[Catholic University Law Review](https://scholarship.law.edu/lawreview)

Volume 46
Issue 1 *Fall 1996*

Article 3

1996

A Comparative Approach to Income Tax Law In the United Kingdom and the United States

William B. Barker

ARTICLES

A COMPARATIVE APPROACH TO INCOME TAX LAW IN THE UNITED KINGDOM AND THE UNITED STATES

*William B. Barker**

INTRODUCTION

Throughout the world, income taxation is one of the principal methods by which nation-states raise revenue to fund ever-increasing governmental expenditure. While several different taxing regimes exist, it comes as no surprise to tax professionals that these different tax systems share many common principles and, indeed, a common language of income taxation. For example, there are many similarities in the various approaches taken to determine exactly what is to be included in the income tax base, and most systems generally compute taxable income by allowing for reductions or deductions for the cost of making profits, including allowances for capital recovery.

Once one begins to focus on specifics, however, these broad similarities may be obscured by the many differences in various income tax laws. Certainly, because of disparities in the political, social, economic, and moral objectives of societies, one would expect differences. These variations might be viewed as simply differences in detail—not substance, such as differences in the time period by which capital may be recovered through depreciation or otherwise. Such distinctions, on the other hand, might be more appropriately characterized as fundamental doctrinal differences regarding the proper approach to the formulation of the tax base. These latter differences provide the focus for this analysis of the British and the American tax structures.

* Professor of Law, The Dickinson School of Law. The idea for this article arose when I taught taxation as a visitor at the London School of Economics and Political Science. I am deeply indebted to Judith Freedman of the London School of Economics and Political Science and George K. Yin of the University of Virginia for their comments on earlier drafts of this article. The usual disclaimer applies.

The study herein is a comparative analysis. Though it commences with a history and outline of the relevant law of the United Kingdom and the United States, it is not limited to simply reporting particular solutions.[1] True comparative law is "the study of the relationship of one legal system and its rules with another."[2] Such a process requires "specific comparative reflections on the problem to which the work is devoted."[3]

The comparative approach followed here seeks to investigate the nature and development of tax law through an examination of the general structure of two systems. By examining each system's approach to the resolution of similar problems, this analysis reflects on the approach and substance of each system. It is, however, axiomatic that such a study can never be entirely systematic because the author must select the subject and problems to study—a necessarily subjective process.[4] Moreover, this author freely admits that the subjects selected were chosen due to the often dramatic way they expose the fundamental nature of the two systems. My objective, however, is to provide an analysis of the consequences of the different approaches.

Alan Watson, a leading authority on comparative law, suggested that comparisons are difficult and may not be particularly worthwhile except when the legal systems are closely related.[5] One needs to examine the general relationship, and one's task is easier if the rules of one system were derived from or influenced by the other.[6] The United States and the United Kingdom share the same general system of law: that is, the common law system of jurisprudence. These two countries offer a natural comparison. But income tax presents a wrinkle in each country's system of law because it is initially a legislative undertaking. Certainly, the colonists did not import the British system of income taxation to America since no such system existed in the United Kingdom until the Napoleonic

1. A study that simply reports particular solutions might be described as "descriptive comparative law." *See* 1 KONRAD ZWEIGERT & HEIN KÖTZ, INTRODUCTION TO COMPARATIVE LAW 6 (Tony Weir, trans., Oxford Univ. Press 2d ed. 1987). For an example of descriptive comparative law in the tax area see COMPARATIVE TAX SYSTEMS: EUROPE, CANADA, AND JAPAN (Joseph A. Pechman ed., 1987).

2. ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW 6 (1974).

3. 1 ZWEIGART & KÖTZ, *supra* note 1, at 6.

4. *See* WATSON, *supra* note 2, at 11 ("To some variable and indefinable extent any study of Comparative Law will be subjective, and no objective test will demonstrate that the aspects considered were the most appropriate and the only ones appropriate.").

5. *Id.* at 7 ("[W]here there is no relationship there can be no Comparative Law, and any comparison drawn between rules will be arbitrary and without systematic worth.").

6. *See id.*

Wars.[7] Nor, as we shall see, did the existing United Kingdom system greatly influence initial tax legislation in the United States.[8] On the one hand, common law systems have methods of finding and applying law that are similar in character, and these methods influence judicial attitudes toward statutes.[9] On the other hand, the British and American statutory schemes could hardly have started farther apart structurally.[10] The study herein demonstrates, however, that the comparison of starkly contrasting systems may actually yield the greatest insight into the nature of legal doctrine.[11]

An effective comparison and critique of the material elements of the respective systems begins with a general definition of the income tax base. Due to its broad approach,[12] the accretion concept of income, sometimes referred to as the Schanz-Haig-Simons approach, has been chosen,[13] as set forth in the work of Henry Simons.[14]

The case for using Simons's work is compelling. He presents a comprehensive, yet simple, definition of income that offers an actual procedure for its measurement. He also provides a useful discussion of other tax theories, which is an important element for comparison because different

---

7. *See infra* notes 27-37 and accompanying text (describing the evolution of the income tax system in the United Kingdom, beginning in 1799).

8. *See infra* notes 61-81 and accompanying text (providing a general overview of the structural differences between the two systems).

9. *See* P.S. Atiyah, *Common Law and Statute Law*, 48 MOD. L. REV. 1 (1985) (exploring the relationship between the common law and statute law). For example, courts in both countries share a similar view of cases reversed by statutes. Atiyah's statement that "[a]s a general rule, the courts tend to regard the statutory reversal of judicial decisions as not affecting the underlying principles of those decisions" reflects this view. *Id.* at 12. An excellent example of this phenomenon under American law is the often-cited case, *Higgins v. Smith*, 308 U.S. 473, 476 (1940) (holding that a taxpayer may not deduct a loss resulting from the sale of securities to a corporation that the taxpayer wholly owns). Section 267 of the U.S. tax code now covers this decision. *See* I.R.C. § 267(a), (b)(2) (1994).

10. *See infra* text accompanying notes 61-81.

11. Indeed, Watson seems to recognize this possibility. In another article he states, "It may well be that at some point in time, the biggest advances in understanding law achieved through looking at various systems will occur by a non-historical investigation of unrelated systems." Alan Watson, *Comparative Law and Legal Change*, 37 CAMBRIDGE L.J. 313, 320 (1978).

12. *See* John G. Head & Richard M. Bird, *Tax Policy Options in the 1980s*, *in* COMPARATIVE TAX STUDIES 3, 9 (Sijbren Cnossen ed., 1983) (discussing the broad application of taxation on personal income as suggested by Henry Simons in 1938).

13. *See generally* ROBERT M. HAIG, *The Concept of Income—Economic and Legal Aspects*, *reprinted in* READINGS IN THE ECONOMICS OF TAXATION 54 (1959) (providing an overview of this approach).

14. *See generally* HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938). Indeed, it is commonplace in tax policy discussions in the United States to start with the work of Henry Simons.

theories have influenced nations' legislative, administrative, and judicial determinations with regard to income tax.

To see this, we begin with a brief examination of several economic theories of income. Simons refers to four distinct senses in which the term income is employed: income from things, social or national income, gain from transactions, and personal income.[15] First, the most common sense in which the term was employed prior to Simons's work characterized income as arising from things, that is, "income may be conceived in terms of services derived from things or, quantitatively, in terms of the market value of uses."[16] Thus, one speaks of income from land or other property, or income derived from the provision of services.

Second, one can speak of social income, or the aggregate results of economic activity during a period which "must equal the aggregate money value of all goods produced and services rendered during the year."[17] Income for tax purposes, therefore, is each individual's share of national income. The similarity in concept between "income from things" and "social income" can readily be seen in comments Adam Smith provided in the *Wealth of Nations*:

> The gross revenue of all the inhabitants of a great country, comprehends the whole annual produce of their land and labour; the neat [net] revenue, what remains free to them after deducting the expense of maintaining; first, their fixed; and, secondly, their circulating capital; or what, without encroaching upon their capital, they can place in their stock reserved for immediate consumption, or spend upon their subsistence, conveniences, and amusements.[18]

The third sense, gain from transactions, deals with changes in the market value of property realized upon sale or other disposition.[19] It deals not only with capital gain but also with trading profits.[20] This sense of income is not a complete conceptual framework, but has been considered an aspect of income.

The fourth sense of income, personal income, is Simons's own contribution, though he acknowledged the important contribution of Haig:[21]

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the

15. *See id.* at 44-47.
16. *Id.* at 44.
17. *Id.* at 45 n.7 (quoting R.T. ELY, OUTLINES OF ECONOMICS 100, 105 (4th ed. 1923)).
18. 1 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 286-87 (R.H. Campbell & A.S. Skinner eds., Oxford Univ. Press 1976) (1776).
19. *See* SIMONS, *supra* note 14, at 44.
20. *See id.*
21. *See id.* at 206.

> change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The *sine qua non* of income is *gain*, as our courts have recognized in their more lucid moments—and gain *to* someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.[22]

These definitions have had different impacts on the British and American tax systems. In general, Simons's definition has deeply influenced the United States.[23] To the contrary, the definitions based on income from things or national income have left a strong imprint on the United Kingdom.[24] Though neither country has religiously conformed its system with these different economic ideals, each system's roots in different traditions can, and has, produced different results.

A warning may be appropriate. One can easily see that Simons's definition of income is the most comprehensive. It not only covers what is included in the first three senses of income, it expands upon them.[25] One would naturally assume that the United States system, more heavily influenced by Simons's concept, is much more comprehensive than that of the United Kingdom. The United States, however, has moved steadily away from comprehensive taxation and, indeed, has adopted some of the restrictive structural features of the British system; some have proposed even further movement in this direction.[26] On the other hand, the United

---

22. *Id.* at 50.

23. *See generally infra* text accompanying notes 38-60 (discussing the development of U.S. income taxation).

24. *See generally infra* text accompanying notes 27-37 (discussing the historical beginnings of the income tax system in the United Kingdom).

25. *See* SIMONS, *supra* note 14, at 44-47.

26. In a 1992 recommendation to Congress, the U.S. Treasury Department stated its long-term policy preference for a "schedular tax on enterprise activity." *A Recommendation for Integration of the Individual and Corporate Tax Systems*, Daily Tax Rep. (BNA) No. 240, at L-7 (Dec. 14, 1992). These recommendations, however, have not lead to any dramatic changes in the taxation of business income to date. The recent tax reform proposal by the Kemp Commission suggests excluding capital gains and income from savings from the tax base. *See* The National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-growth, Pro-Family Tax System for the 21st Century*, *in* 70 TAX NOTES 413, 424-25 (1996). The Kemp Commission's proposal requires the application of the source-based, schedular principles of taxation found in the United Kingdom. *See infra* text accompanying notes 66-70 (describing the relationship between the concept of source and a schedular income tax system).

Kingdom system has moved away from the limitations imposed by the narrower definition. More surprisingly, however, the very structure derived from the United Kingdom system's more limited starting point has expanded the scope of the tax base, in some instances, beyond that found in the tax law of the United States.

This Article is divided into two sections. Section I compares and contrasts the history and structure of British and American income tax law, emphasizing conflicting views of income, deductions, losses, business taxation, and capital gains and losses: Section II examines the concepts of realization and taxable event as they have developed from the structure and history of the two systems.

I. THE ORIGINS AND STRUCTURE OF BRITISH AND AMERICAN INCOME TAXATION

A. *United Kingdom: The First Comprehensive Income Tax System*

Income taxation began in the United Kingdom due to the serious need for revenue to support war efforts during the Napoleonic Wars.[27] In 1799, the United Kingdom adopted what has often been called Pitt's tax, a comprehensive tax on the income of residents from real property, personal property or any other property, and income from any "profession, office, stipend, pension, employment, trade or vocation."[28] It also included any income not falling under any of the specific rules,[29] including income arising or sourced both inside and outside the United Kingdom.[30] The tax was progressive, including several graduated rates of tax up to a maximum rate of ten percent.[31] A single return was required for income from all sources.[32]

27. *See* 2 STEPHEN DOWELL, A HISTORY OF TAXATION AND TAXES IN ENGLAND 208-09 (3d ed. Frank Cass & Co. 1965) (1884).

28. 3 *id.* at 92-93 (citing Income Tax Act, 1799, 39 Geo. 3, ch. 13 (Eng.)).

29. The Act provided for the following income to be charged:

I. Income from land, including houses, which comprised —

1. Income of owners;
2. Income of tenants; and
3. Income of mesne lessors under demises in consideration of fines.

II. Income from personal property, and from trades, professions, offices, pensions, stipends, employments, and vocations.

III. Income arising out of Great Britain.

IV. *Income not falling under any of the foregoing rules.*

Id. at 93 (emphasis added).

30. *See id.* at 92-93.

31. *See id.* at 94.

32. *See id.* at 93-98 (providing an example of the return).

The United Kingdom's flirtation with a nonschedular income tax system was short-lived. In 1803, Addington's Property and Income Tax was enacted.[33] The system introduced by this tax was in reaction to strong taxpayer objections to the previous system that forced the taxpayer to disclose his entire "circumstances in life" on one return to one government official.[34] Thus, in 1803, schedular income taxation was born. Addington's tax required a taxpayer to file particular returns for income based on a particular source for that income.[35] In 1803, there were five schedules,[36] which became the basis of the United Kingdom's modern income tax system. Addington's tax retained exemptions for small incomes in the aggregate and a graduated rate system.[37] Thus, although the system was schedular, it still required the amalgamation of income for assessing the final taxable amount.

B. The Birth of Income Taxation in the United States: Comprehensive Income Taxation at Its Zenith

Consistent with the origin of income tax in the United Kingdom, the first national income tax in the United States was instituted during a time of fiscal crisis.[38] The first income tax was enacted in 1861 at the commencement of the Civil War.[39] The 1861 Act was simple, the charge to tax being less than half a page.[40] Though the 1861 Act was sparse on definitions, the charge was to tax income to the fullest extent.[41]

---

33. *See id.* at 99 (citing Property and Income Tax Act, 1803, 43 Geo. 3, ch. 122 (Eng.)).

34. *Id.*

35. *See id.*

36. *See id.* at 99-101. The schedules were Schedule A (land), Schedule B (farming), Schedule C (public funds), Schedule D (trades, professions, vocations), and Schedule E (public office or employment of profit, pensions, stipends). *See id.*

37. *See id.* at 101-02.

38. *See* EDWIN R.A. SELIGMAN, THE INCOME TAX 430-31 (1911).

39. *See id.*; Revenue Act of 1861, ch. 45, § 49, 12 Stat. 292, 309 (repealed 1862).

40. The 1861 Act provided:

> That, from and after the first day of January next, there shall be levied, collected, and paid, upon the annual income of every person residing in the United States, whether such income is derived from any kind of property, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatever, if such annual income exceeds the sum of eight hundred dollars, a tax of three per centum on the amount of such excess of such income above eight hundred dollars . . . .

§ 49, 12 Stat. at 309.

41. *See id.* Notable exceptions from an ideal comprehensive income base included gifts and bequests of real property and gains from the sale of real property that was not purchased within two years of the sale. *But see* Act of Aug. 27, 1894, ch. 349 § 27, 28 Stat. 509, 553 (specifically *including* these items in "income" to be taxed under the Act); *see also infra* note 61.

Graduated rates first appeared in the 1862 amendments to the original Act.[42] The rates were three and five percent, and the first six hundred dollars of income were exempt from tax.[43] Rates were greatly increased in 1865, to five and ten percent.[44] This first experiment with income taxation terminated, as scheduled, in 1872, amid considerable controversy over the wisdom of continuing the tax.[45]

The United States's next encounter with income tax came in 1894.[46] The 1894 Act provided for a two percent tax on all incomes above four thousand.[47] The 1894 Act defined income fairly comprehensively and included for the first and only time "money and the value of all personal property acquired by gift or inheritance."[48] The 1894 Act was short-lived, however, because the United States Supreme Court in 1895 found significant provisions to constitute an unconstitutional direct tax.[49]

Thirty-six states ratified the Sixteenth Amendment to the United States Constitution, thereby making income taxation a reality.[50] The Sixteenth Amendment ended the debate as to whether the federal government had the power to impose an income tax on its citizens.[51] However, the true starting place for modern income taxation in America is the 1913 law that implemented the Sixteenth Amendment.[52]

The 1913 Act continued the tradition of a comprehensive tax base, including both domestic and foreign income, and a progressive system characterized by graduated rates.[53] Except for the fact that the 1913 Act excluded gifts and inheritances,[54] which Congress was considering treat-

42. *See* Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473 (amended 1865).

43. *See id.*

44. *See* Act of Mar. 3, 1865, ch. 78, 13 Stat. 469, 479.

45. *See* ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX, 1861-1913 53-56 (1993).

46. *See* Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553. The Supreme Court declared the Act largely unconstitutional in 1895. *See* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 583-84, *modified by* 158 U.S. 601, 637 (1895).

47. *See* § 27, 28 Stat. at 509.

48. *Id.* § 28.

49. *See Pollock*, 157 U.S. at 583-84.

50. *See* JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 75 (1985).

51. The Sixteenth Amendment provides, "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

52. *See* Act of Oct. 3, 1913, ch. 16, 38 Stat. 114 (codified as amended at I.R.C. §§ 1-9722 (1994)).

53. *See* § 2, 38 Stat. at 166-81.

54. *See* WITTE, *supra* note 50, at 78.

ing in a separate tax structure,[55] it comprehensively defined income[56] and fully taxed capital gains.[57] Moveover, the 1913 Act explicitly defined deductible expenditures for the first time.[58] A somewhat unusual feature of the 1913 Act (vis-à-vis current United States tax law) was its heavy reliance on the withholding of the base rate of tax at its source.[59] In this

---

55. *See id.*

56. The 1913 Act defined net income as follows:

> That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent . . . .

§ 2, 38 Stat. at 167.

57. *See id.* Differential rates for capital gains did not become law until 1921. *See* Revenue Act of 1921, ch. 136, § 206, 42 Stat. 227, 232-33 (codified as amended at 26 U.S.C. §§ 1201-88 (1994)).

58. The 1913 Act defined allowable deductions as follows:

> That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due to the taxpayer actually ascertained to be worthless and charged off within the year; sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made . . . .

§ 2, 38 Stat. at 167.

59. The 1913 Act provided for withholding of income tax at the source by:

> All persons, firms, copartnerships, companies, corporations, joint-stock companies or associations, and insurance companies, in whatever capacity acting, including lessees or mortgagors of real or personal property, trustees acting in any trust capacity, executors, administrators, agents, receivers, conservators, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual gains, profits, and income of another person, exceeding $3000 for any taxable year . . . .

Id. at 170.

narrow instance, the British practice may have influenced United States law.[60]

C. An Elementary Structural Overview

When one looks at the origins of income taxation in both the United States and the United Kingdom, it is perhaps noteworthy that both systems began with a comprehensive tax base surprisingly close to the ideal of the economists. For different reasons, both systems excluded gifts or inheritances,[61] and the United Kingdom did not tax capital gains.

Both systems initially adopted a synthetic or global income tax structure as opposed to an analytical or schedular one. Synthetic or global taxation begins with a holistic approach to income; income is treated the same no matter what its kind or source. Moreover, synthetic taxation often is linked to residence as opposed to a source principle of international taxation.[62] Schedular systems, on the other hand, separate income into its constituent parts; they "take as their starting point solely the

---

60. *See* H.R. REP. No. 63-5, at 1-6 (1939), *reprinted in* 1939-1 C.B. 1. In its report, the House Ways and Means Committee stressed that it had carefully considered the income tax systems of other countries. *See id.* at 3. The Committee's statement is worth considering today:

> In the light of the experience of other countries, we recommend the passage of this income-tax provision, in the confident belief that as soon as this tax and its administrative machinery become fairly understood by the people and adjusted by the country its operation and effects will meet with as much satisfaction as any tax law. The tariff taxes, being invisible and intangible, are paid into the Treasury without any accurate knowledge on the part of the taxpayer, either as to the amount he pays to the Treasury or the much larger amount he at the same time pays to the protected manufacturer. It is well, therefore, that the people should know, at least as to the substantial portion of their taxes, the true amount paid. All taxes, National, State, and local, come alike off the American people.
>
> A personal knowledge of the amount of taxes required of the people would more closely enlist their interest and active cooperation in all the affairs of government, and especially with respect to revenues and expenditures. The adoption of the proposed tax, therefore, would assist in arousing and sustaining general public interest in behalf of economy at all times.

Id.

61. Although gifts had been taxed in the United States under the 1894 Act, *see* Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. 509, 553 (codified as amended at I.R.C. § 102 (1994)), Congress anticipated in 1913 that gifts might more appropriately be the subject of an estate and gift transfer tax. *See* Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 167; *see also supra* notes 54-55 and accompanying text. In the United Kingdom, gifts are not taxed to the recipient because they do not have a source.

62. *See* ARNOLD A. KNECHTLE, BASIC PROBLEMS IN INTERNATIONAL FISCAL LAW 36-37 (W.E. Weisflog trans., 1979). Knechtle refers to this as the "*residence-*, *universality-*, *totality- principle.*" *Id.*

sources of income and restrict themselves to taxing incomes which originate from *internal, domestic* sources."[63]

The United States has, at least in form, consistently followed a synthetic approach to income taxation.[64] In several areas, however, schedu-

63. *Id.* at 37. Source taxation applies to income on the basis of the income's relation to the taxing jurisdiction. Residence or status taxation taxes income on the basis of the relation of the taxpayer to the taxing jurisdiction. *See id.* at 36-37. The schedular system adopted later in the United Kingdom, however, never limited itself to domestic source income, but included foreign source income earned by residents.

64. Corporate taxation in America, the classic system that taxes income first at the corporate level, and second, at the shareholder level, may, upon first consideration, appear schedular in nature. This treatment of corporate income, however, springs from quite a different conceptual starting point. The theory behind economic double taxation is that the corporation is truly a separate taxpayer apart from its owners as a result of the privilege of limited liability. Under this scheme, neither the income nor the net loss of the enterprise is directly attributable to the shareholders due to the limitations on the shareholders' economic risk. Income is not the shareholders' until distributed; loss is possible only through diminution of the value of the owners' stock.

Modern corporate taxation became law in 1909, four years before the passage of the Revenue Act of 1913. *See* Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 112 (codified as amended in scattered sections of 26 U.S.C.). Despite the characterization of the corporate tax as a tax on income, the tax withstood constitutional challenge. *See* Flint v. Stone Tracy Co., 220 U.S. 107, 144-47, 151-52 (1911), *overruled on different grounds by* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528 (1985). The tax withstood constitutional challenge due to the Supreme Court's conclusion that the tax was an excise tax on the "doing of business." *Id.* at 145-46.

Recently, considerable attention has been paid to the reform of the corporate tax system in the United States. Various proposals have been suggested for the integration of the corporate and individual tax systems. *See, e.g.*, U.S. DEP'T OF TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992) [hereinafter REPORT ON INTEGRATION]; John K. McNulty, *Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects*, 12 INT'L TAX & BUS. LAW. 161 (1994) (analyzing American Law Institute and U.S. Treasury Department tax reform proposals). Integration models have, as their starting point, the view that the income earned by a corporation is ultimately that of its shareholders. REPORT ON INTEGRATION, *supra*, at vii ("[O]ur tax system taxes corporate profits distributed to shareholders at least twice - once at the shareholder level and once at the corporate level.").

Entity taxation, however, can have some schedular features. Under current U.S. law, a complete pass-through entity model of taxation, like partnership taxation and Subchapter S corporate taxation, is essentially synthetic because the income or loss is integrated with the owner's other income. Partnership taxation is mildly schedular due principally to the law's restriction on the deduction of losses to the partner's basis in his partnership interest (outside basis), and the Internal Revenue Code's treatment of some transactions between partners and their partnerships as transactions between strangers. *See* I.R.C. §§ 704(d), 707(a) (1994). Subchapter S corporate taxation is more schedular due to the shareholders' inability to include corporate debt in their stocks' basis for purposes of loss allowance. *See id.* § 1367. Corporate integration as found in Europe, or in proposals advanced by the U.S. Treasury, however, is true scheduler taxation. *See generally* REPORT ON INTEGRATION, *supra*. Corporate integration includes the segregation of income from shareholders and its separate taxation, the inability of shareholders to deduct operating losses of the corporalar principles have crept into the system, several of which will be examined in this section.[65] The United Kingdom, on the other hand, quickly abandoned a synthetic approach with the adoption of Addington's schedular system. In analyzing the impact of this structure on taxation in United Kingdom, it is helpful to compare it with pure schedular taxation, and to see where the United Kingdom differed.

The schedular system adopted in the United Kingdom started with the concept of income from things.[66] Thus, critical to understanding the British system is the concept of source. Income is taxed only if it has a source, and only if that source is enumerated in the taxing act.[67] Although the doctrine of source could be applied either in a synthetic or an analytical system,[68] "[h]istorically, the source concept is probably rooted in schedular income tax systems."[69] By contrast, the American system taxes income from "whatever source derived."[70]

The choice of system may ultimately make no difference. Total income should be the same under the source and accretion concepts if every source of income was defined comprehensively. This statement holds true when source is not meant to be a limiting feature of taxation. The United States system views source in this way.

---

tion, and, in most cases, the application of rates to corporate income different from those rates applied to the individual shareholders. *See id.*

65. Examples include various loss limitation provisions such as the passive activity loss rules, I.R.C. § 469, rules concerning capital losses, *id.* § 1211, rules concerning investment interest, *id.* § 163(d), and rules limiting certain deductions to the amount at risk, *id.* § 465.

66. *See supra* notes 14-16 and accompanying text (describing Simons's theory of the concept of income from things).

67. *See* Brown v. National Provident Inst., [1921] 2 App. Cas. 222, 227 (appeal taken from K.B.). *National Provident* was originally decided by the High Court of Justice, King's Bench Division. Under the British system of courts, tax cases begin at the trial level, where General or Special Commissioners decide the issues. The first appeal of the decision of the trial court is heard by the High Court. The second appeal is heard by the Court of Appeals. If granted a final appeal, the parties are heard before the House of Lords. *See* THE CHARTERED INSTITUTE OF TAXATION, BUTTERWORTHS UK TAX GUIDE, 1995-96, at 45-49 (14th ed. 1995) [hereinafter BUTTERWORTHS]. The form of the modern English judgment, dating from 1830, gives "the detailed opinion of the Chief Justice or the presiding Judge, the opinion of the other Lords or judges on the Bench, in so far as they add anything to that of the President, and the opinion of the *dissentientes*." HENRI LÉVY-ULLMANN, THE ENGLISH LEGAL TRADITION 119 (M. Mitchell trans., Frederic M. Goodby ed., 1935).

68. *See* Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913) (holding that "'income' may be defined as the gain derived from capital, from labor, or from both combined"); *see also* Eisner v. Macomber, 252 U.S. 189, 207 (1920) (adopting *Stratton*'s definition). Thus, the Supreme Court suggested that income must have a source.

69. R. MANSURY, THE INDONESIAN INCOME TAX: A CASE STUDY IN THE REFORM OF A DEVELOPING COUNTRY 52 (1992).

70. I.R.C. § 61(a) (1994).

Where source derives its context from schedules, however, synthetic and analytical systems do not unite. Schedular taxation gives nations the option of being highly selective in the kinds of income taxed, and they may easily use schedular taxation to tax different income at different rates. The process of assigning income to schedules limits taxable income unless there is a category for all other income. Allowable deductions are easily fine tuned for each kind of income. Schedules are meant to provide boundaries, and boundaries change the complexion of income.

Contrary to the classical notion of schedular taxation, income tax in the United Kingdom was meant to be a comprehensive system of income taxation. Internationally, it adopted a residence principle and has maintained it ever since. The switch from Pitt's synthetic tax to Addington's schedular tax was intended to change administration, not substance. Schedule D, the most significant schedule in Addington's tax since it dealt with trade and business income and the professions, had a sweeping clause that taxed persons on income from any sources other than those specifically charged under the other schedules.[71] Yet, interpretation transformed the doctrine of the source into a doctrine of limitation.

Thus, one limitation on a comprehensive income tax base in the United Kingdom came less from the structure chosen than from the view of the definition of income. The British system started with the concept of income from things and additionally required that these sources be activities pursued for profit.[72] Source in the United Kingdom, therefore, was defined subjectively as a thing or activity that reasonable men pursue for profit. The catchall provision of Schedule D also incorporated this concept. The British courts consistently interpreted the catchall provision as including only items that are comparable to items taxed from enumerated sources.[73] The notion of income from things also meant that the income must be separate or severable from its source, and that the source must endure even though income might fluctuate. Use values were considered income but the property itself was not.[74] Thus, the category of income from transactions, or the sale or exchange of capital assets (non-business property), was not recognized in the British system. Income from the sale of property was taxed only if it arose from the conduct of a trade.[75]

71. *See* DOWELL, *supra* note 27, at 100-01.

72. *See generally* FRANCIS EUGENE LABRIE, THE MEANING OF INCOME IN THE LAW OF INCOME TAX (1953).

73. *See* Graham v. Greene, 2 K.B. 37, 41 (1925) (Eng.); *see also* BUTTERWORTHS, *supra* note 67, at 577-78.

74. *See, e.g.*, Brown v. National Provident Inst., [1921] 2 App. Cas. 222, 245-46 (appeal taken from K.B.); *see also supra* text accompanying notes 16-17 and note 69.

75. *See infra* note 151.

Taxation of capital gains only came about in the United Kingdom in 1965.[76]

In both the United States and the United Kingdom, the courts played a major role in defining and determining the parameters of the tax system. The defining characteristic of analysis by United States courts was the concept of income, or, whether the taxpayer had gain. By contrast, courts in the United Kingdom "tried to enumerate the source of income as a substitute for defining income."[77]

One of the most difficult problems facing income tax systems is distinguishing between personal and profit-making activities. In the United Kingdom, since source was defined in terms of profit, personal activities were excluded from the scope of the income tax law.[78] In the United States, however, gain was income no matter the source. In the United Kingdom, the appropriate analysis was of profit from enumerated activities.[79] In the United States, the approach to net income was bifurcated into conceptually distinct categories of income and deductions.[80] The distinction between personal and profit-making activities was irrelevant to the question of income. This distinction became an essential element in the United States, however, in testing the deductibility of expenditures which are restricted, in the main, to profit-making activities.[81]

1. The Consequences of Starting Points

United Kingdom law, since 1803, has provided that income is taxed if it falls within one of the Schedules.[82] This system has been implemented

---

76. *See* Finance Act, 1965, ch. 25, § 19 (Eng.).

77. Yoseph Edrey, *Income Tax Base: Moving from the British Source Doctrine to the "American Concept of Accretion to Wealth" - the Israeli Experience*, 3 TRANSNAT'L LAW. 427, 432 (1990) (quoting A. NAMDAR, TAX LAWS: THE SUBSTANTIVE LAW, INCOME TAX, CORPORATE TAX, CAPITAL GAIN TAX 41-42 (1985)). Indeed, one of the major criticisms levelled at the British income tax system is its lack of a coherent view of income. *See, e.g.*, J.A. KAY & M.A. KING, THE BRITISH TAX SYSTEM 70-71 (2d ed. 1980).

78. For consideration of this statement in the capital gains context, see *infra* text accompanying notes 320-324.

79. *See, e.g.*, Finance Act, 1995, ch. 4, § 39 (Eng.) (providing schedular taxation).

80. *See* John Tiley, *Judicial Anti-avoidance Doctrines: The US Alternatives*, 1987 BRIT. TAX REV. 180, 187.

81. The principal sections for deductions are I.R.C. § 162 (1994) *amended by* Pub. L. No. 104-7, 109 Stat. 93, § 1(a)-(b) (1995) (allowing deductions for trade or business expenses) and I.R.C. § 212 (allowing deductions for the production of income or investment). Certain personal expenditures are deductible in some circumstances: mortgage interest, I.R.C. § 163(h)(2)-(h)(3), state and local taxes (excluding sales taxes), *id.* § 164, and charitable contributions, *id.* § 170.

82. *See* Income and Corporation Taxes Act, 1988, ch. 1, § 1 (Eng.) (setting out the schedular tax system); *see also supra* notes 35-37 and accompanying text (describing Addington's Property and Income Tax).

through a series of acts dealing with activities in separate categories with little need to provide unifying principles applicable to all Schedules.[83] In United States law, however, taxes include "all income from whatever source derived."[84] American legislation has been designed as a unified code updated and synthesized continuously. Somewhat similar to a civil code, the Internal Revenue Code's major provisions, *viz* the general rules for income and deduction, consist of broad pronouncements with undifferentiated content.[85] Such direction has given courts and governmental administrative bodies great latitude to interpret or supply content in order to deal with evolving economic conditions. The courts, in exercising their powers, assumed that Congress meant to exercise "the full measure of its taxing powers"[86] under the Sixteenth Amendment. Thus, the critical theoretical debate in the development of American tax law concerned the nature of income. Any possible limitation that the notion of source might have had on this doctrine was finally put to rest by the United States Supreme Court in *Commissioner v. Glenshaw Glass Co.*[87] In doing so, the Court provided an often quoted definition of income: "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[88]

In the United Kingdom, however, the source of income became a dominant concern. This may well have been caused by the heavy reliance the United Kingdom system places on collecting tax at the source rather than primarily through a tax return system. Today, except in the case of employment income and the taxation of foreign taxpayers,[89] the United States system places little reliance on collection of tax at the source.

The doctrine of the source first requires the identification of a statutory source, such as specific property, trade, or employment, and second, the

83. *See* Income and Corporation Taxes Act, 1988, ch.1 (Eng.) (stating in the preamble that the Act's purpose was to consolidate previous enactments).

84. I.R.C. § 61(a).

85. *See, e.g.*, I.R.C. §§ 61, 162 (1994) (discussing the broad definition of income and the application of various tax deductions).

86. Helvering v. Clifford, 309 U.S. 331, 334, 337-38 (1940) (finding broad congressional power in the interpretation of income as defined by the Revenue Act of 1934).

87. 348 U.S. 426, 429-30 (1955) (supporting the liberal construction of income as Congress's intent); *see also supra* note 68 (discussing Eisner v. Macomber, 252 U.S. 189 (1920), where the Supreme Court suggested that income must have a source).

88. *Glenshaw Glass Co.*, 348 U.S. at 431.

89. *See* I.R.C. § 3402 (1994) (employment); *id.* §§ 1441, 1442 (foreign taxpayers). The principal withholding system in the United Kingdom is the PAYE system, which provides for withholding taxes on employment income. *See* Finance Act, 1994, ch. 9, §§ 125-133 (Eng.). It differs from the American withholding system for employment, I.R.C. § 3402, in that it precisely measures an employee's tax obligation in order to obviate the need for a tax return and any post taxable year adjustments. *See id.*

careful linking of a possible taxable amount to that source.[90] A corollary of the rule is that there can be only one appropriate schedule for a particular item of income.[91]

a. The Absence of an Appropriate Source

In several instances, United Kingdom courts have recognized the presence of income but have concluded that it is not taxable under any Schedule. In *Graham v. Greene*,[92] for example, the taxpayer had considerable winnings from betting on horses.[93] Indeed, betting was practically his only means of livelihood.[94] The question presented was whether the taxpayer's winnings were taxable under Schedule D as either profits and gains of a trade (Case I), vocation (Case II) or other income (Case VI).[95] Recognizing that the winnings were income,[96] the court nevertheless concluded that they were not gains or profits from a taxable source.[97] Even though carried on regularly, the taxpayer's betting activity was not a trade or vocation, the court reasoned, because a bet was an irrational agreement.[98] The court recognized that a bookmaker, on the other hand, is in trade and is, therefore, taxable under Schedule D.[99] The bookmaker's profit is made by offsetting the risks associated with different bets.[100] If the court had recognized gambling as a trade, an undesirable consequence would have been that gambling losses could be freely deducted and could be used to offset profits from other activities.[101]

In the United States, tax law specifically addresses this latter problem by limiting deductions for wagering losses to the amount of wagering gains.[102] Furthermore, under United States law, the tax issue typically begins and ends with the question of income. Thus, taxable income re-

90. *See* Mitchell & Edon v. Ross, 1962 App. Cas. 814, 838 (appeal taken from C.A.).

91. *See* Fry v. Salisbury House Estate, Ltd., 1930 App. Cas. 432, 439 (appeal taken from C.A.).

92. [1925] 2 K.B. 37.

93. *See id.* at 38.

94. *See id.*

95. *See id.* at 39.

96. In conclusion, Rowlatt, J., remarked: "All I can say is that in my judgment the income which this gentleman succeeded in making is not profits or gains . . . ." *Id.* at 42.

97. *See id.* The activity of racing thoroughbred horses is also considered to be a personal activity, not a trade. Winnings, therefore, are not taxable. *See* Sharkey v. Wernher, 1956 App. Cas. 58, 67 (appeal taken from C.A.); *see also* discussion *infra* part II.C.1.

98. *See Graham*, [1925] 2 K.B. at 39-40.

99. *See id.* at 41; *see also* Partridge v. Mallandaine, [1887] 18 Q.B. 276, 277-78.

100. *See Graham*, [1925] 2 K.B. at 41-42.

101. *See id.* at 40.

102. *See* I.R.C. § 165(d) (1994).

sults from gambling simply because it represents the inflow of an economic benefit.

Windfalls in the nature of found cash or goods are also not taxed under the British tax system because there is no taxable source.[103] This result differs from United States law, which dictates that found goods or treasure trove are, indeed, taxable income because they represent inflows of economic benefits, even when the taxpayer may not have absolute ownership.[104]

In the United Kingdom, the most important source of income not covered by the schedules was historically income the disposition of capital assets produced.[105] As Judge Rowlatt stated in *Graham*:

> A person who buys an object which subsequently turns out to be worth more than he gave for it, and which he sells, does not thereby make a profit or gain for income tax purposes. But he can organize himself to do that in a commercial and mercantile way, and the profits which emerge are taxable profits, not of the transaction, but of the trade.[106]

b. Causation—Income and Its Source

Due to the source requirement, some British doctrines prevent taxation if the income in question is not sufficiently related to the particular source. Three employment cases decided by the courts illustrate this problem.[107]

In *Hochstrasser v. Mayes*,[108] an employer agreed to reimburse his employee for any loss incurred on the sale of the employee's residence when the employer required the employee to move.[109] Schedule E charges an employee on emoluments of an office or employment.[110] To be chargeable, an emolument must be made "in reference to the services the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future."[111] The court concluded that since the employee had otherwise been fairly paid for his

103. *See Graham*, [1925] 2 K.B. at 39.

104. *See* Cesarini v. United States, 296 F. Supp. 3, 5 (N.D. Ohio. 1969), *aff'd*, 428 F.2d 812 (6th Cir. 1970) (citing Rev. Rul. 61, 1953-1 C.B. 17).

105. For further discussion of the current law on capital gains in the United Kingdom and the United States, see *infra* Part II.C.3.

106. *Graham*, [1925] 2 K.B. at 41.

107. *See infra* text accompanying notes 108-22.

108. 1960 App. Cas. 376 (appeal taken from C.A.).

109. *See id.* at 378-79.

110. Income and Corporations Tax Act, 1988, ch. 1, § 19 (Eng.).

111. *Hochstrasser*, 1960 App. Cas. at 388.

work, the payment was not a payment for services, but a payment for the loss and, hence, nontaxable.[112]

In *Pritchard v. Arundale*,[113] the court concluded that a signing bonus, given to a prospective employee as encouragement to leave his present employment, was not sufficiently related to the services to be performed, and therefore, was not taxable.[114] Lord Simonds's statement, cited in that case, illustrates well the philosophy that prevails in the United Kingdom:

> [I]t was not for the subject to prove that his case fell within exceptions arbitrarily inferred from the statute, but for the Crown to prove that the tax was exigible. After a little discussion, I think that [counsel for the Crown] accepted that the true issue was not the twofold question whether the benefit fell within the taxable category of remuneration for services (as it may briefly be described) or within the non-taxable category of personal gift, but a single question, namely, whether or not it fell within the taxable category of remuneration for services. "Personal gift" is thus not a category which has to be defined or explained, but merely an example of a transaction which will not fall within the taxable category of remuneration for services. In other words, the question is not one of which of two strait-jackets the transaction best fits, but whether it comes within the statutory language, or else, failing to do so, falls into the undefined residuary class of cases not caught by the statute.[115]

In *Moore v. Griffiths*,[116] a professional football player received a bonus from the Football Association, an organization of which his club was a member, as well as a bonus from a private company for winning the World Cup Competition in 1966.[117] The court recognized that the taxpayer's relation to the Football Association was in a sense an employment relation. A study that simply reports particular solutions might be described as "descriptive comparative law."[118] In the case of the private concern, however, there was no employment relation and "[t]he prizes were plainly offered in order to publici[z]e the company's products."[119] Because the employee performed services without any expectation of benefits from either organization, the bonuses were in the nature of a

112. *See id.* at 396-97.
113. [1971] 1 Ch. 229.
114. *See id.* at 241.
115. *Id.* at 237 (citations omitted).
116. [1972] 1 W.L.R. 1024 (Ch.).
117. *See id.* at 1027.
118. *See id.* at 1034.
119. *Id.* at 1035.

windfall, rather than consideration for services rendered and, thus, were not taxable income.[120]

In the United States, courts might reach different conclusions under the facts of *Hochstrasser* and *Pritchard* as to whether the payments were sufficiently related to employment. Under United States law, the context—employment versus trade—might affect the overall tax result.[121] Such classifications, however, are irrelevant in determining whether the payments are included in the definition of taxable income. The receipt of an economic benefit is taxable income irrespective of its relation to a particular source. All the receipts in the cases discussed above would be considered income in the United States. Although United States courts might agree that a transfer from a third party, as in *Moore*, is not a payment for services, such a transfer would still be taxed as income under the general principle that even prizes and awards are income.[122]

2. *Integration Versus Disintegration*

Let us review the essence of the differences between the starting points found in United States global and United Kingdom schedular taxation, which are located at opposite ends of the spectrum. The United States starts with a comprehensive scheme that treats all income alike irrespective of its sources and generally allows deductions of any type as long as the expenditures relate to profit-making activities. The United Kingdom taxes income only from particular sources, and even though these sources are defined fairly comprehensively, segregates computations from each other. The United Kingdom grants deductions only on a Schedule-by-Schedule, and sometimes case-by-case, basis. Nevertheless, the British system today is in many ways an integrated system, just as the American system has incorporated many elements of schedular taxation. As will be shown, the British system's continued reliance on schedular principles often ensures the integrity of the general taxing scheme. For the same reasons, schedular principles have been introduced in the United States in an attempt to cure perceived abuse and to ensure the integrity of the system.

---

120. *See id.* at 1034-35.

121. For example, a person's duty to withhold depends on that classification. *See* I.R.C. §§ 3401-3406 (1994).

122. See *Hornung v. Commissioner*, 47 T.C. 428, 440 (1967), in which an American football player was taxed on the value of a car provided by a magazine in recognition of his exceptional play in a National Football League championship game. *See also* I.R.C. § 74 (1994) ("[G]ross income includes amounts received as prizes and awards.").

The most important impetus to integration is progressive taxation.[123] Fair progressive taxation depends upon the amalgamation of all income for the purpose of applying tax rates. In the United Kingdom today, all income is combined for purposes of applying graduated income tax rates. Even capital gains, which are not chargeable as income per se, and are subject to their own separate tax regime, are now integrated and taxed at the taxpayer's highest marginal income tax rate.[124]

Once incomes are combined for purposes of applying rates, one must ask if only positive net incomes from each schedule are combined, or whether net losses are also utilizable. Before answering that question, though, one should consider how a net loss can be created. Paramount to consideration of this problem is the role of depreciation and interest deductions in the tax system because they are the principle sources of net losses from profit-making activities.

In general, capital allowances or depreciation deductions in the United Kingdom are limited to trades under Schedule D, Case I.[125] There are two limited exceptions. Schedule A, which deals with the holding of real property, permits capital allowances for machinery and equipment,[126] but not for buildings.[127] Thus, capital allowances are not permitted for other profit-making activities, including professions and employment.

Interest expense is generally deductible for trades, professions, and, in appropriate cases, employment.[128] For purposes of the activity of holding real property, interest is an allowable deduction on loans of thirty thousand pounds or less when incurred to purchase or improve one's personal residence.[129] Another provision allowing a taxpayer to deduct interest in the case of commercial lettings was repealed in 1995.[130]

Schedule F includes corporate distributions or dividends of resident companies subject to credit for corporate income taxes paid.[131] Stock is a

123. A progressive tax is one where the average rate of tax on all income increases as the income of the taxpayer increases. This is usually accomplished by means of a graduated rate structure.

124. *See* Taxation of Chargeable Gains Act, 1992, ch. 12, § 4 (Eng.).

125. *See* Income and Corporation Taxes Act, 1988, ch. 1 §§ 74, 82 (Eng.) (addressing tax deductions as applied to residents and non-residents); *see also* BUTTERWORTHS, *supra* note 67, at 442.

126. *See* Income and Corporation Taxes Act, § 32.

127. Buildings are not considered to be wasting assets when their useful life exceeds fifty years. *See* Taxation of Chargeable Gains Act § 44. Nevertheless, even buildings with a useful life less than fifty years are not depreciable under Schedule A because the deduction is not specifically allowed. *See id.*

128. *See* Income and Corporation Taxes Act §§ 74, 82, 356 (amended 1995).

129. *See id.* §§ 354, 355, 357.

130. *See* Finance Act, 1995, ch. 4, § 42 (Eng.).

131. *See* Income and Corporation Taxes Act, § 231(2).

non-depreciable asset, and Schedule F does not permit the deduction of interest incurred to carry stock investments.[132] For purposes of capital gains taxation, interest is not treated as part of the allowable deductible cost of an asset.[133]

In the United Kingdom, losses from activities most likely arise in the context of a trade. Losses are less likely to arise in the case of rental activity and are very unlikely to arise in the case of employment. Since interest is not allowed as a deductible expense, losses are not possible in the case of stock ownership. However, the gain or loss from the sale or disposition of stock assets is subject to capital gains taxation, but not income taxation.

In integrating income under the British system for purposes of applying progressive tax rates, operating losses can be used only to offset other income when such losses arise from the carrying on of a trade (Schedule D, Case I), a profession or vocation (Schedule D, Case II), or employment (Schedule E).[134] A further hurdle for loss relief, which allows Inland Revenue to question the bona fides of the activity, requires that the trade be undertaken on a commercial basis and have a reasonable expectation of profit.[135] No other losses can be used to offset income in general.

In keeping with principles of synthetic taxation, United States tax law did not historically distinguish among profit-making activities.[136] Thus, depreciation and interest expenditures are freely deductible.[137] Under a

132. *See id.* § 20.

133. *See* Taxation of Chargeable Gains Act, 1992, ch. 12, § 38(3) (Eng.). In the case of companies, when interest is required to be capitalized as part of the cost of buildings, structures, or works, such interest is treated as a cost for capital gains purposes. *See id.* § 40.

134. *See* Income and Corporation Taxes Act § 380. Losses produced by transactions taxed under Schedule D, Case VI (other income) can only be offset by gains within that section. *See id.* § 392.

135. *See id.* § 381(4). Under U.S. law, the hobby loss provision similarly limits a taxpayer's deductions to the amount of his or her income if the activity is "not engaged in for profit." I.R.C. § 183(a) (1994).

136. In 1954, Congress passed I.R.C. § 212, which allowed individual taxpayers to take deductions for expenses incurred in investment activities. Section 212 overruled the U.S. Supreme Court's limiting decision in *Higgins v. Commissioner*, 312 U.S. 212 (1941), which held that expenses incurred in looking after one's investments are not incurred in "carrying on a business" and are, therefore, not deductible. *Higgins*, 312 U.S. at 217-18. Also, capital gains taxation became an exception to this rule starting in 1921. *See* Witte, *supra* note 50, at 91.

137. *See* I.R.C. § 162, *amended by* Pub. L. No. 104-7, § 1(a)-(b), 109 Stat. 93, 93 (1995) (allowing a deduction for "ordinary and necessary" business expenses); *id.* § 163 (indebtedness interest); *id.* § 167 (depreciation of property "used in trade or business" or "held for the production of income"); *id.* § 212 ("ordinary and necessary" investment expenses). Interest on a mortgage on one's personal residence is also deductible under United States law. *See id.* § 163(h)(3).

global system, there is no restriction on the deductibility of net losses against any income. Nor is there any reason to identify such losses as a special category other than as a potential carryover deduction to another year. Under a global system, the charge to tax is for net income from all the activities of the taxpayer within the taxable period. Income and deduction are neither differentiated nor segregated with regard to source. Due to varying policy choices, the United States Congress, however, has over the years instituted several qualifications to the ideal system first introduced in 1913.[138]

Several provisions introduce schedular notions. Under these provisions, interest and depreciation are still generally deductible subject to schedular notions of segregation of activities. For example, taxpayers often finance the acquisition of investment assets such as stocks, bonds, and other interest-bearing investments. A possible profit expectation is a trade-off between the tax savings generated by current deductions and the tax cost of future income, which might be recognized as capital gain. United States law now limits the interest deduction attributable to such assets to the amount of the investment income, thus preventing a net loss that could result from such interest deductions offsetting other income.[139] The law provides that the interest deductions that create the net loss are suspended and can be carried forward and utilized under the same procedure in a later year.[140]

The passive activity loss rules limit deductions even more broadly.[141] These provisions limit the deductibility of net losses from ordinary business activities when the taxpayer does not materially participate in the activity.[142] The rationale is that taxpayers who do not devote sufficient energy to an activity may be using the activity primarily for the purpose of generating losses that would typically offset other taxable income the taxpayer generated. Significantly, the real estate activity of holding depreciable rental property (a building or improvement) in the United

138. *See infra* notes 141-45 and accompanying text.
139. *See* I.R.C. § 163(d)(1).
140. *See id.* § 163(d)(2).
141. *See id.* § 469.
142. *See id.* "Material participation" under § 469 has been partially defined as "any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done." Treas. Reg. § 1.469-5(f) (1996); *see also* Temp. Treas. Reg. § 1.46a-5T (1996).

States[143] is defined as a per se passive activity.[144] Generally, in the United States, § 469 limits net losses from passive activities to the extent of net gains from other passive activities.[145]

3. Capital Gains or Losses

Until recently, the United Kingdom did not recognize capital gains as a form of income.[146] The United States, on the other hand, originally treated capital gains like any other form of income.[147] Today, however, taxation of capital gains in the United States is a hybrid of schedular and global principles. Thus, there are several similarities between laws governing the taxation of capital gains in the United Kingdom and the United States.

The Revenue Act of 1921 changed capital gains taxation forever in the United States by introducing a special maximum tax rate for capital gains.[148] The present United States system is similar in that capital transactions are segregated from other income. Under both the British and American systems, the deductibility of capital losses is restricted to total capital gains.[149] As previously noted, the British system taxes capital gains at regular rates,[150] whereas American law still provides for a special maximum rate.[151]

The United Kingdom system adds net capital gain to income in order to determine the appropriate rate of tax. Allowable operating losses can

143. *See* I.R.C. § 167, *amended by* Pub. L. No. 104-88, § 304(a), 109 Stat. 803, 943 (1995) (describing the general rules governing applicability); *id.* § 168 (describing the methods used in determining depreciation deductions).

144. *See id.* § 469(c)(2).

145. *See id.* § 469(a), (d).

146. Taxation of capital gains began as a system wholly separate from income taxation in 1965. In 1979, capital gain rates were integrated with the income tax system. It is clear that, at least since 1979, capital gains have been considered income. *See* Capital Gains Tax Act, 1979, ch. 14, §§ 1-3 (Eng.), *reenacted* Taxation of Chargeable Gains Act, 1992, ch. 12 §§ 1, 2 (Eng.).

147. *See* Act of Oct. 3, 1913, ch. 16, § 2, 38 Stat. 114, 166 (including within taxable income, each individual's "entire net income from all property owned and every business, trade, or profession").

148. *See* Revenue Act of 1921, ch. 136, § 206, 42 Stat. 227, 232-33 (defining capital gain).

149. *See* I.R.C. § 1211. In the United States, there is a small exception to the rule that permits the deduction of a net capital loss up to $3000 per year for individuals. *See id.* § 1211(b). In the United Kingdom, losses are restricted because capital transactions are subject to a separate tax regime that taxes net gains. *See* Taxation of Chargeable Gains Act § 1.

150. Note, however, that indexing of one's expenditures (or basis) is allowed in the United Kingdom for capital gains tax purposes. *See* Finance Act, 1982, ch. 39, § 86(1), (4) (Eng.).

151. *See* I.R.C. § 1(h).

be used only to offset income, not capital gains. Therefore, capital gains will be taxed, at least, at the lowest rates.

The United States system first treats capital gains and allowable taxable losses as any other income. Then, any net capital gains may be totally offset by the excess of deductions over income from other activities. Deductions for this calculation could include business and investment deductions, personal deductions such as residence mortgage interest and local taxes, charitable contributions, and personal exemptions.

What constitutes a capital asset taxed under these provisions? Both the American and British systems define capital assets as any form of property.[152] The principal exception under both tax systems concerns the treatment of stock in trade.[153] Though the United States definition of capital asset excludes land or depreciable property used in a trade or business,[154] United States law provides capital gains treatment for such assets under a separate section.[155] Thus, both the British and American capital gains systems, in their treatment of the disposition of assets associated with profit-making activities, often produce current income subject to tax when held by the taxpayer. This characteristic of both systems creates two problems that affect the integrity of capital gains taxation.

First, a common problem is the transmutation of ordinary income into capital gains, or capital losses into ordinary losses. In the United States, the favorable tax rate for capital gains and the restricted deduction of capital losses is the underlying cause of the transmutation problem. Historically in the United Kingdom, transmutation of ordinary income was significant because capital gains were not taxed. Today, the distinction between capital transactions and ordinary income is still significant due to the British system's inclusion of indexing expenditure (or basis) for capital gain and loss purposes and the nondeductibility of net capital losses.[156]

Treatment of the income from the sale of depreciable property demonstrates how each system resolves one facet of the transmutation problem. The sale may produce gain attributable to loss of expenditure (or basis) due to depreciation deductions that have previously offset ordinary business income. Such gain should not be a candidate for capital gains treat-

152. *See id.* § 1221; Taxation of Chargeable Gains Act § 21(1).

153. *See* I.R.C. § 1221(1); Taxation of Chargeable Gains Act § 161.

154. *See* I.R.C. § 1221(2).

155. *See id.* § 1231 (providing that when the combination of all transactions results in a net gain, all transactions will be considered capital; when the combination results in a net loss, all transactions will be considered non-capital, and losses will not be limited to gains).

156. In general, the United Kingdom does not tax gains attributable to inflation. An allowance that reduces the amount of the chargeable gain is calculated based on a portion of the cost of the asset. Taxation of Chargeable Gains Act §§ 53, 54. Capital losses created by the allowance get limited relief. *See* Finance Act, 1994, ch. 9, § 93 (Eng.).

ment, and both systems prevent such a result. In the United Kingdom, gains realized to the extent of prior depreciation deductions become balancing charges that reduce depreciation allowances for that year.[157] In addition, the expenditure (or basis) that is indexed for capital gains purposes does not include that portion that has been subject to capital allowances (depreciation).

Generally, in the United States, gain realized to the extent of prior depreciation is treated as ordinary income.[158] For non-real property, such gain is completely recaptured as ordinary income.[159] United States law, however, is incomplete because gains from real property are only recharacterized as ordinary income to the extent of the excess of accelerated depreciation over straight line depreciation.[160] Thus, in the case of real property, substantial gains can be transmuted into capital gains. In contrast, United Kingdom tax law does not even allow depreciation for rental real property.[161]

Second, the problem of interest expenditures affects the integrity of capital gains taxation. When asset acquisition is financed, interest becomes one cost factor in determining the overall profitability of an asset in producing both current income and capital appreciation. When assets produce insufficient current income, interest deductions can create current losses offsetting other income.

Generally, in the United States, interest incurred pursuing profit-making activities is deductible. As noted before, however, there are general loss limitation sections that affect the deductibility of interest. First, § 163(d) restricts interest deductions incurred to acquire or carry financial instruments, including stocks and bonds, to the amount of income such capital assets produced.[162] As defined, income includes gains from the sale of such assets, but only when the taxpayer elects to treat such gains as ordinary income.[163]

Second, the passive loss rules work similarly in deferring net losses. Any interest deduction would be fully allowable, at the latest, upon the disposition of the activity for which it was incurred. Thus, the steeper the differential between regular tax rates (presently 39.6% maximum)[164] and

157. *See* Capital Allowances Act, 1990, ch. 1, §§ 24, 26 (Eng.).
158. *See* I.R.C. §§ 1245(a)(1), 1250(a).
159. *See id.* § 1245(a)(1), (3).
160. *See id.* § 1250(a)(1), (2), (3), (b)(1). Today, real property can only be depreciated using a straight line method. *See id.* § 168(3).
161. *See* Taxation of Chargeable Gains Act §§ 38, 39, 53(2), (3) (failing to include rental real property in depreciation provisions).
162. I.R.C. § 163(d).
163. *See id.* § 163(d)(4)(B)(ii), (iii).
164. *See id.* § 1.

capital gains rates (presently 28% maximum),[165] the greater the incentive is to finance investment assets.

Because the United Kingdom does not have preferential treatment for capital gains, the system does not provide the same incentive to finance capital assets as the American tax system. The British practice of indexation of capital assets, however, presents a different concern. If interest incurred to carry assets is deductible, such interest deductions must also be indexed if capital gains or losses are to be properly reflected.[166] Unindexed interest encourages tax arbitrage.

Consider the following example that illustrates the effect that tax savings have on the viability of an investment that otherwise would break even economically. Assume a taxpayer buys property for $100,000 financed by a loan at 10% payable in one year. On the date of loan repayment, the taxpayer sells the property for $110,000. Other than tax consequences, the investment yields neither gain nor loss. Assume the taxpayer is taxed at a rate of 40%, the approximate maximum United States rate. The 28% rate for capital gains applies only in the United States. The British indexing allowance, where applicable, is 5% this year. The example presents various possibilities:

1. *Without Indexing*

	U.S. tax (int. ded.)	*U.K. tax (no int. ded.)*	*U.K. tax (if int. ded.)*
Interest Deduction (tax savings)	4000	0	4000
Capital Gains Tax	2800 (28%)	4000 (40%)	4000 (40%)
Profit/Loss After taxes	1200	[4000]	0

2. *With Indexing*

	U.S. tax	*(no U.K. int. ded.)*	*(if int. ded.)*
Interest Deduction (tax savings)	4000	0	4000

165. *See id.* § 1(h).

166. *See generally* BROOKINGS INSTITUTION, INFLATION AND THE INCOME TAX (Henry J. Aaron ed., 1976); DEPARTMENT OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977); INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION 136-37 (1978) (discussing concerns regarding indexing interest) [hereinafter INSTITUTE FOR FISCAL STUDIES]; VITO TANZI, INFLATION AND THE PERSONAL INCOME TAX: AN INTERNATIONAL PERSPECTIVE (1980).

Capital Gains Tax	1400 (28% of 5000)	2000 (40%)	2000 (40%)
Profit/Loss After Taxes	2600	[2000]	2000

Example 2, column 2 represents the outcome in the United Kingdom. Unlike interest under American law, interest is not freely deductible. Because of the limitations under British law, conversion of interest deductions into indexed capital gain is difficult, if not impossible. As demonstrated earlier, interest is not freely deductible except for income from trades or professions under Schedule D. If a trade acquires assets, the assets are either stock in trade (non-capital) or property used in the trade. In the latter category, if the assets are depreciable, there is no indexing of depreciated expenditures. If the assets are not depreciable, their use value is consumed in the business, presumably to make profits, so that the interest expenditures relate to income chargeable under Schedule D. Shares, unless stock in trade, are not taxed under Schedule D. Thus, the segregation of assets prevents the translation of interest deductions into indexed gains or losses, except for the possibility of non-depreciable business assets.

Example 1 demonstrates the outcome under the United States system and presents an obvious case for leveraging. Moreover, the American system lacks the inherent safeguards found within the British system. British taxing concepts cannot be introduced without fundamentally changing the nature of the American system. A further incentive for American taxpayers to leverage would exist if the American system adopted indexation, since interest is freely deductible. Capital gains taxation would become a profitable area for tax arbitrage. Unindexed interest deductions would be regularly exchanged for indexed capital gains, turning economically unsound transactions into profitable after tax activities.

II. Realization, the Taxable Event, and Crossing Schedular Lines

A. *Introduction*

The timing of a transaction affects whether and when income is taxed. Consequently, tax systems must be designed to recognize the impact of timing. The concept of realization is critical to questions of timing and plays a central role in both the British and American income tax systems.

Realization is an important concept both in the areas of capital gains and losses, and in the timing of ordinary business (and other income) receipts. The classic application of the doctrine occurs when economic gains (or losses) result from mere fluctuations in the market value of assets the taxpayer owns.

Early economic theories of income clouded the issue of taxation of capital gains and losses. Under these theories, capital gains and losses were excluded from income. Under a later economic theory of income, gains and losses from transactions, or, classic realized capital gains and losses were included in income. This later theory inspired the world's first system of capital gains taxation in the United States.

Economic theory later expanded to include, as income, changes in the market value of assets—a classic accretion concept of income. Simons specifically rejects the notion that gain realization is necessary for taxation of capital gains and losses. Tax legal theory, however, rejects Simons approach. Hence, taxable income, as distinguished from economic income, does *not* include the mere appreciation or depreciation in value of assets until such time as the gain or loss is realized at the sale or other disposition of the asset.[167]

In the United Kingdom, Judge Rowlatt expressed this principle in *Royal Insurance Co. v. Stephen*:[168]

> At the bottom of this principle of waiting for a realization, I think there is this idea: while an investment is going up or down for Income Tax purposes the Company cannot take any notice of fluctuations, but it has to take notice of them when all that state of affairs comes to an end, when that investment is wound up . . . [and] ceases to figure in the Company's affairs, when it is known exactly what the holding of that investment has meant, plus or minus to the Company, and then the Company starts so far as that portion of its resources is concerned with a new investment. Then one knows where one is and it is no longer a question of paper, it is a question of fact and that is a realisation.[169]

In *Royal Insurance*, realization occurred when the taxpayers had received new shares of stock in exchange for old, pursuant to a government-ordered reorganization of certain companies.[170] The court recognized that only the form of investment had changed, and admitted that the case presented a close question.[171] Ultimately, the court found that the reor-

167. *But see* I.R.C. § 1256 (taxing unrealized gain and loss on commodity futures and contracts marked to market and creating an exception to the general rule that unrealized gain or loss is not taxed).

168. 14 T.C. 22 (K.B. 1928).

169. *Id.* at 28.

170. *See id.*

171. *See id.* at 29.

ganization had terminated the investment in the old stock and allowed the taxpayer a loss deduction.[172]

In the United States, the most famous explication of this principle is found in *Eisner v. Macomber*,[173] in which the Supreme Court held that a proportionate common stock dividend on common stock shares was not income.[174] There, the underlying rationale was stated as follows:

> Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being "*derived*," that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; — *that* is income derived from property.[175]

Thus, "enrichment through increase in value of capital investment is not income in any proper meaning of the term."[176] The importance of realization to the definition of income has been reiterated by the United States Supreme Court time and again.[177]

Realization also has a role in the determination of ordinary income. Tax accounting principles are wedded to the requirement of realiza-

---

172. *See id.*
173. 252 U.S. 189 (1920).
174. *See id.* at 219.
175. *Id.* at 207.
176. *Id.* at 214-15.
177. *See, e.g.*, Cottage Sav. Ass'n. v. Commissioner, 499 U.S. 554, 559 (1991) (involving the sale and purchase of mortgages); Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-32 (1995) (involving the classification of punitive damages as income).

tion,[178] which can be illustrated by the accrual (U.S.)[179] or earnings (U.K.)[180] methods of accounting.

The realization requirement is driven by the need for objective measurability and by the uncertainty of income. When firms create products or services for sale in the ordinary course of business, a continuous process of creating or adding value exists. From an economic viewpoint, this process is a continuous accession to income. An accretion concept of income would require the measurement of the value of products or services continuously during, or at least as of the last day of, the taxable year. How can one accurately measure that value? The choice of an arbitrary date for measurement makes valuation extremely difficult and impractical. Accrual accounting thus rejects accretion theory and adopts a realization requirement. Put succinctly:

> [T]he product or service can be measured best by the money or money equivalent expected to be received for the product at some time in the future. It is the uncertainty of this expected receipt and the search for verifiable measurements that have led accountants to the adoption of specific rules for the timing of revenue.[181]

178. *See* Willingale v. International Commercial Bank Ltd., 1978 App. Cas. 834, 838-39, 841 (appeal taken from C.A.) (noting that profit may be taxed when realized, namely when it has been ascertained and earned); Ostime v. Duple Motor Bodies, Ltd., [1961] 2 All E.R. 167, 170-71 (H.L.) (discussing realization principles in determining the appropriate accounting methods for stock in trade and work in progress taxation).

The requirement of realization found in *International Commercial Bank* and *Duple* is still the law today. There is a possibility that the requirement of realization may lose some of its force in the determination of business profits because tax accounting under British law is tightly wedded to financial accounting practice. Moreover, the holding of a recent case suggested that financial accounting principles may control tax accounting. *See* Gallagher v. Jones, 1994 Ch. 107, 134. Thus, tax accounting may change in accordance with changes in financial accounting, and there is an indication that the realization requirement may be changing for financial accounting purposes. *See* Judith Freedman, *Defining Taxable Profit in a Changing Accounting Environment*, 1995 BRIT. TAX REV. 434, 442 n.46.

Needless to say, the possibility that changes in financial accounting may control tax results, as the recent decision in *Gallagher* suggested, has sparked considerable debate and criticism in the United Kingdom. *See generally* 1995 BRIT. TAX REV. 433 (presenting a special issue exploring the relationship between accounting standards and taxable profits). By contrast, in the United States, tax accounting is a well-developed field independent from financial accounting. *See, e.g.*, STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING § 1.01[4] (2d ed. 1993) (discussing the distinction between financial and tax accounting in the United States).

179. *See* GERTZMAN, *supra* note 178, § 1.02[2] (describing the accrual method).

180. For an account of the earnings basis under British law, see generally Judith Freedman, *Profit and Prophets—Law and Accountancy Practice on the Timing of Receipts—Recognition Under the Earnings Basis (Schedule D, Cases I & II)*, 1987 BRIT. TAX REV. 61.

181. ELDON S. HENDRIKSEN, ACCOUNTING THEORY 181 (3d ed. 1977).

Thus, accrual accounting requires the inclusion of income where the obligation to be paid arises and the amount can be determined with reasonable accuracy. In such a situation, "[t]he likelihood of collection is so high in the normal business situation and collection so routine that complete realization of revenue may be assumed."[182]

The difficulty of accurate measurement makes determination of the real income less certain. Realization also addresses another kind of uncertainty: even if value is known at a particular point in time, that value is transitory and taxation may result on income that will never be made real in the conventional sense. For example, when a merchant keeps an item instead of disposing of it, for whatever reason, the true economic measure of income is not the item's present fair market value, but the present discounted value of a future receipt for that item. Consider, for example, a nursery business. "The present discounted value is difficult to determine because it depends upon expectations of future market prices and the costs of harvesting and preparing the product for market."[183] In some instances, as with nursery stock or livestock, the product has an ascertainable market price at each stage of growth.[184] In these cases, valuation is simplified.[185] These measurements, however, while verifiable, are but estimates of discounted net future values.[186] The likelihood of change in value adds uncertainty to any accurate determination of economic income. Such uncertainty has been eliminated in a sale when the taxpayer has fixed the maximum value by the expected receipt.[187]

The same policy considerations apply to capital assets, but with potentially greater force, because these assets are more likely to be held long term. Another rationale often raised for the requirement of realization is the taxpayer's lack of readily available funds to pay the tax if accretion in value were taxed. Simply implying that the taxpayer could sell the prop-

---

182. Sidney Davidson, *The Realization Concept*, *in* MODERN ACCOUNTING THEORY 99, 107 (Morton Backer ed., 1966).

183. HENDRIKSEN, *supra* note 181, at 186.

184. *See id.*

185. *See id.*

186. *See id.*

187. *See id.* Deductions do not seem to be governed by the same realization requirements. The tax system allows a deduction due to the expectation that an expenditure will be used and quickly consumed to produce income. Under accrual accounting, a deduction is allowed when the obligation to pay arises, even though the object of the expenditure may still have utility in the business. The doctrine of capitalization (where the utility of an expenditure is lengthy) and inventory accounting methods prevent deduction before realization. Realization occurs, for purposes of deduction, when the product or service created is disposed of. In the case of capitalized expenditures for wasting assets, depreciation deductions that are based on estimates of the decline in value may occur also before realization.

erty might be an unsatisfactory solution since some assets might be difficult to sell. Lack of liquidity of some assets is another rationale for the concept of realization.

Thus, an important commentator, Marvin Chirelstein, speaks of the tax system in the United States as a "tax on *transactions*,"[188] instead of a tax on income—at least in the economic sense.[189] Boris Bittker, another important commentator, states that, "The income tax depends on 'transactions' or 'taxable events' and is not a tax on 'income' as defined by economists."[190] These general statements do not mean that the American system ignores economic income for some other theory of income. Rather, the requirement of realization is generally understood as changing the timing of the reporting of economic income in the modern sense. If realization changes only the timing of economic income, and not its substance, then it follows that tax systems tax economic income that has been crystallized by a transaction or other taxable event.

The following sections compare and contrast the different applications of the concept of realization when taxpayers move assets between businesses, convert assets from business to personal use, and conversely, convert assets from personal to business use. If realization occurs in these situations, economic gain will be reported. When assets are transferred between trades or businesses, both the British and American systems adopt a similar understanding of the doctrine. While the United Kingdom also applies this theory in other contexts, the United States does not. As a result, in the case of conversions between business and personal use, the United States system has developed a patchwork of different theories directed at curing the problems that result from the absence of direct taxation of these events.

B. Assets: Qualitative Change in Use

As previously noted, the paradigm for the application of realization is capital appreciation. Both the British and American systems begin with the notion that gain is not real unless it results from a market transaction. Both systems, however, also face a myriad of situations that test their abilities to fairly and consistently raise the revenues their governments require. Faced with different situations, each system has taken a different approach in defining realization. Analysis of the different approaches illuminates the nature, adequacy, and necessity of the concept of realization.

188. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 72 (7th ed. 1994).
189. *See id.*
190. WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 299 (8th ed. 1990).

Turning away from capital assets and examining normal business transactions reveals much about realization and taxation. Indeed, the United Kingdom and the United States have provided us with two "chicken cases" that challenge conventional wisdom.

In the British case, *Watson Bros. v. Hornby*,[191] the taxpayers operated businesses consisting of a chicken hatchery and brooder houses.[192] The hatchery raised day-old chicks, most of which were sold in the normal course of business.[193] However, some were retained to be raised in the brooder houses, part of the farm's stock of birds.[194]

In contrast to the United States tax system, income from the two activities had to be reported on different Schedules. The parties eventually agreed that the hatchery was deemed to be a business reporting its profits under Schedule D, whereas the brooder activity was considered a farm activity reporting its income under Schedule B.[195] In addition, since the activities were assessable under different Schedules, the parties agreed that an adjustment of accounts was required for chicks "transferred" from the hatchery to the brooder houses.[196] The difficult question revolved around the basis on which the adjustment was to be made.[197]

The facts showed that the cost per chick to the hatchery business was seven pence.[198] The brooder house could purchase chicks on the open market for four pence per chick.[199] While recognizing that the hatchery and the farm were two separate activities, Inland Revenue argued that a person cannot trade with himself or suffer losses by transferring goods from one division to another and concluded that the hatchery must be credited with seven pence per chick, the cost of production.[200]

Inland Revenue's position that realization cannot occur when one deals with oneself has a certain intuitive appeal. And yet, the court rejected Inland Revenue's case, finding instead for the taxpayers. While recognizing the usual truth of Inland Revenue's theory, the court concluded that in this case it was "necessary to regard the hatchery and the farm as sepa-

---

191. 1942 All E.R. 506 (K.B.).
192. *See id.* at 506.
193. *See id.*
194. *See id.*
195. *See id.* at 506-07. This latter principle had been established in the United Kingdom just before *Watson Bros.* was decided. *See* Long v. Belfield Poultry Prods., Ltd., 21 T.C. 221, 229-30 (K.B. 1937) (holding poultry farming activities to be assessable under Schedule B and hatching under Schedule D). Schedule B is no longer part of British tax legislation.
196. *Watson Bros.*, 1942 All E.R. at 507.
197. *See id.*
198. *See id.*
199. *See id.*
200. *See id.* at 507; *see also* Sharkey v. Wernher, 1956 App. Cas. 58, 69 (appeal taken from C.A.) (noting that a man "cannot trade with himself").

rate entities."[201] Thus, a sale was deemed to have been made between such entities at a reasonable or market price.[202]

This result naturally followed from the fact that the schedular system applies different schemes and rates to different kinds of income. Using cost would have permitted an economic loss incurred by the hatchery to be transferred to, and utilized by, the brooder house, thereby distorting the true profit of the different enterprises.

The result entitled the taxpayer to an immediate tax loss. The taxpayer also benefitted because the hatchery's trade losses could be set off against income in general, while the losses attributable to the brooder house, a farming activity, could not.[203] Fundamentally, the loss in value of the chicks was attributable to the period in time that the chicks belonged to the hatchery business. It was therefore only fair that the taxpayer be entitled to the loss.

Yet, was this a realized loss? The court used the device of a *notional* sale to determine the value of the transaction for tax purposes.[204] Notional, meaning imaginary, is the opposite of realization, which means real or actual. While the sale was imaginary, the price was not. Similar market transactions established the price. Realization, however, typically requires a market transaction that confirms the reality of the actual transaction producing the loss. One of the major reasons for realization—the problem of determining market values—was absent here. On the other hand, the property's value was still subject to market forces and fluctuations. Thus, when the taxpayer, as here, still retains the property after the transaction has closed, the loss is not readily apparent.

Realization is often linked with the concept of a taxable event. Whether we speak of income, or deductions in general, or losses, we are searching for an event or events that render taxation appropriate. In *Watson Bros.*, the taxpayer experienced a taxable event as a result of the transfer of chicks from the hatchery to the brooder house—in other words, a transfer from one tax Schedule to another. Due to the nature of the schedular system, these happenings could not be ignored.

The *Watson Bros.* interpretation of the requirement of realization includes the concept of deemed realization. At the hatchery, the normal course was to sell the chicks at one-day old. Market value was easily ascertained at that point. When a taxpayer reaches the point at which there is an established market for an asset, and instead, chooses to devote

201. *Watson Bros.*, 1942 All E.R. at 507.
202. *See id.* at 507-08.
203. *See supra* text accompanying notes 136-37.
204. *See Watson Bros.*, 1942 All E.R. at 508.

that property to a different use, arguably a deemed disposition sufficient to satisfy the requirement of realization has been made, especially when the integrity of the schedular system would otherwise be compromised.

United States law also has a chicken case of similar significance. In *Burgess Poultry Market, Inc. v. United States*,[205] the taxpayer, a corporation, was engaged in the business of raising and processing poultry.[206] Prior to starting its farm operation, the taxpayer had purchased all the requirements of its processing business on the open market.[207] Afterwards, its farm division produced broilers for its processing division, providing approximately forty percent of the processing division's total intake.[208]

The issue before the court was whether the farm division's use of the cash method of accounting clearly reflected the income of the taxpayer in light of the processing division's use of the accrual method of accounting.[209] The court determined that the taxpayer's actions were entirely appropriate.[210]

The importance of this decision lay less in its holding than in its unstated commentary on United States tax law. The United States Treasury authorizes taxpayers to use different accounting methods for trades or businesses that are separate and distinct.[211] The ability to treat the businesses independently for tax purposes is, however, somewhat elective due to the Internal Revenue Service (Service) requirement that separate books or records be kept for all trades or businesses desiring to be considered separate and distinct.[212]

Once two divisions of a single business are considered separate and distinct for tax purposes, the question arises as to the proper treatment of the movement of goods between them. Since each division maintains separate books and records, the transfer of property from one business to the other must be reflected. The potential problems and possible solu-

205. 64-2 U.S. Tax Cas. (CCH) ¶ 9515, at 93,163 (E.D. Tex. 1964).

206. *See id.* at 93,163.

207. *See id.*

208. *See id.* at 93,165.

209. *See id.* at 93,166.

210. *See id.*

211. *See* Treas. Reg. § 1.446-1(d)(1) (1995). The question whether two activities of a taxpayer are separate and distinct is a factual question. In a later poultry case, the Eighth Circuit upheld a District Court finding that a hatchery division and broiler division were "too interdependent and well-integrated" and lacked a "sufficient separation of books and records" to be considered separate and distinct. Peterson Produce Co. v. United States, 313 F.2d 609, 611 (8th Cir. 1963). In *Peterson*, the taxpayer was not permitted to use separate accounting methods for the two divisions. *See id.*

212. *See* Treas. Reg. § 1.446-1(d)(2).

tions are thus the same as those faced by the British court in *Watson Bros.*

The transfer might be considered merely a bookkeeping adjustment, so that when inventory property is transferred, cost is removed from the transferror's inventory and treated as an expenditure by the acquiring business. If so, the property becomes a nullity for the first business because the original inclusion and later exclusion result in a wash. Since the first business in *Burgess Poultry* was a cash basis taxpayer, upon transfer, the taxpayer would be compelled to treat the original deducted costs as income. The second business would continue as if it had originally acquired the property at the taxpayer's original cost. Assuming the property is inventory, the taxpayer's original cost would be included as a purchase in calculating the cost of goods sold for the second business.[213]

From the perspective of a single taxpayer, simply shifting the original cost from one business to another is obviously consistent with a view of realization that, no gain or loss is realized when the property simply moves to another pocket of the same taxpayer. Even though there are two businesses, the general practice of United States tax law is to put all of an individual taxpayer's activities together in one return, subject to one tax. Unlike the situation in *Watson Bros.*, where the integrity of the schedular system was at stake, the only issue in *Burgess Poultry* was one of timing.[214] Remarkably, however, the court in *Burgess Poultry* did not follow this logic.

Instead, the court in *Burgess Poultry* treated the events as notional sales of the chicks by the farm division to the broiler processing division at the prevailing market price at the time of transfer.[215] The court based this treatment on the actual conduct of the taxpayer, who handled all transactions between the divisions as formal sales with invoices and transfer payments by check.[216]

213. Simply put, inventory accounting determines income on the basis of two formulas: gross income is determined by subtracting the cost of goods sold from gross sales; the cost of goods sold is determined by adding opening inventory to purchases and then subtracting closing inventory.

214. Certainly, U.S. tax law has adopted some features of the schedular system in order to segregate certain activities of the taxpayer. *See, e.g.*, I.R.C. § 469 (1994) (limiting losses from passive activities to the amount of gain); *id.* § 465 (limiting deductions to the amount at risk of loss for certain activities); *id.* § 902 (listing foreign tax credit rules); *see also supra* text accompanying notes 61-93 (comparing the synthetic (U.S.) and schedular (U.K.) approaches to income taxation). Since these rules result in different taxation for different activities, there is perhaps more at stake now under American law than at the time *Burgess Poultry* was decided.

215. *See Burgess Poultry*, 64-2 U.S. Tax Cas. (CCH) at 93,165.

216. *See id.*

The courts in *Watson Bros.* and *Burgess Poultry* reached the same result. In both cases, the taxpayer advocated and established the position that gains and losses that do not satisfy conventional notions of realization should be deemed realized for tax purposes.

One might conclude, at least in *Burgess Poultry*, that the taxpayer effectively waived the claim of realization by treating the divisions separately and electing different accounting methods. The government, however, did not waive realization. In addition, if the Commissioner makes the determination as to whether separate and distinct businesses in fact exist, then it follows that he or she may require different accounting methods in order to clearly reflect the income of each business.[217] This, then, weakens the argument that a taxpayer may waive the realization claim by way of separate divisions and accounting methods. Even in these latter cases, the principles of *Burgess Poultry* requiring a notional sale should apply.

The consequences of these decisions profoundly affect our understanding of the concept of realization. Under British law, the schedules separate a taxpayer's activities into discreet components for tax purposes, requiring notional sales in order to properly assess the profits of the activities. In the United States, accounting principles sometimes permit, or even require, the taxpayer to treat different activities as separate businesses. When the focus is on the activity as a discrete business, the clear reflection of income standard requires that the income of each business be clearly reflected as an *entity*. It stands to reason that the income of each separate business is clearly reflected only when it is credited with the gains and losses incurred during the time it owned the property. This would be determined on the basis of notional sales at fair market value.

Thus, deemed realization may exist when a taxpayer's activities are divided up for tax purposes, and there is a need to clearly reflect the actual income of each activity. How far this concept can, and is, extended under British and American law will be seen in the next section. Ultimately, we must address the question of whether deemed realization is realization or its negation.

C. *Redeployment of Property Between Business and Personal Use*

Taxation has always recognized the distinction between business and personal activities, and has paid considerable attention to keeping these activities separate. When a taxpayer intentionally crosses the line sepa-

217. *See* Parker v. Commissioner, 37 T.C. 331 (1961). In *Parker*, the Commissioner successfully changed the accounting method of one of the taxpayer's businesses without changing the other. *See id.* at 339.

rating these activities by transferring property from one activity to another, tax law must provide appropriate treatment. As we shall see, British tax law has faced these problems directly and simply whereas American tax law has employed many theories to deal with such transactions. The role of realization is at the heart of the different approaches.

1. *Conversion of Stock in Trade from Trade to Personal Use: The British Experience*

In viewing British law, we are incredibly fortunate to have an authoritative case that is both comprehensive in scope and detailed in explanation. In *Sharkey v. Wernher*,[218] the House of Lords considered the case of a taxpayer, Lady Zia Wernher, who was engaged in several activities with regard to thoroughbred racehorses.[219] Lady Wernher was involved in the activity of breeding horses, some of which she would later use to race.[220] Some of these race horses would then be returned to the stud farm for breeding.[221]

The issue before the House of Lords was how to account for the transfer of the horses from the stud farm to the racing establishment. Specifically, should the accounts of the stud farm be credited with the cost of production or with the market value of the horses?[222] At issue was whether the House of Lords would accept the principles of *Watson Bros. v. Hornby*[223] and apply them in this different context.

The situation in *Sharkey* differed from that in *Watson Bros.* due to another peculiarity of the schedular system. The stud farm was a trade or business taxable under Schedule D.[224] The racing establishment, on the other hand, was considered a recreational activity, free from taxation under any schedule.[225] Though clearly the activity could produce income or loss, such income or loss did not have a taxable source under British tax law.[226] Thus, unlike the court in *Watson Bros.*, the House of Lords had to deal with the conversion of stock in trade to personal use, not to a different business use.

218. 1956 App. Cas. 58 (appeal taken from C.A.).
219. *See id.* at 59-60.
220. *See id.* at 59.
221. *See id.*
222. *See id.* at 61.
223. 1942 All E.R. 506 (K.B.); *see supra* notes 191-204 and accompanying text (discussing *Watson Bros.*).
224. *See Sharkey*, 1956 App. Cas. at 59.
225. *See id.*
226. *See generally supra* text accompanying notes 82-91 (discussing the effects of schedular taxation).

Viscount Simonds, the Chief Justice, spelled this out as follows:[227]

> The problem, therefore, in all its simplicity, is whether a person, carrying on the trade of farming or, I suppose, any other trade, who disposes of part of his stock in trade not by way of sale in the course of trade but for his own use, enjoyment, or recreation, must bring into his trading account for income tax purposes the market value of that stock in trade at the time of such disposition.[228]

Viscount Simonds also recognized the immense scope of this issue and its importance in British law:

> It is, as I have said, a surprising thing that this question should remain in doubt. For unless, indeed, farming is a trade which in this respect differs from other trades, the same problem arises whether the owner of a stud farm diverts the produce of his farm to his own enjoyment or a diamond merchant, neglecting profitable sales, uses his choicest jewels for the adornment of his wife, or a caterer provides lavish entertainment for a daughter's wedding breakfast. Are the horses, the jewels, the cakes and ale to be treated for the purpose of income tax as disposed of for nothing or for their market value or for the cost of their production?[229]

Adopting the principles of *Watson Bros.*, the House of Lords concluded that the conversion from business to personal use must be considered a disposition by way of trade.[230] Furthermore, the House of Lords treated the disposition as a notional sale at market value.[231]

The problem that the House of Lords faced in *Sharkey* began with an unanticipated glitch in the tax system. The converted property was stock in trade and an entry had been made in the taxpayer's inventory account. Something had to be done because transfer of the item to personal use without adjustment would have resulted in the cost of the property being deducted as a cost of the items sold in trade.[232]

What makes *Sharkey* so clearly unique is the Lords' choice of the remedy of a notional sale for value over a cost adjustment[233] in the year of

227. *See supra* note 67 (discussing the form of the modern English judgment).

228. *Sharkey*, 1956 App. Cas. at 68.

229. *Id.* at 69-70.

230. *See id.*

231. *See id.* The court noted by way of passing that in some cases an arbitrary or conventional sum might be agreed upon. *See id.*

232. As discussed later, the American system also requires that an adjustment be made. *See infra* Part II.C.2.

233. The taxpayer's solution was that cost simply should be added to sales. *See Sharkey*, 1956 App. Cas. at 69.

the conversion. The following comments by Viscount Simonds on this issue should provoke serious thought:

> An attempt has been made to justify the notional receipt of a sum equal to the cost of production by treating such a receipt as the equivalent of an expenditure which in the event proved not to have been for the purpose of trade, since the article was not disposed of in the way of trade. But this is pure fiction. Up to the very moment of disposition (in this case the transfer of a horse from stud farm to racing stable) the article was part of the trader's stock in trade and the cost of its production was properly treated as part of his expenditure for income tax purposes. I see no justification for an ex post facto adjustment of account which in effect adds to a fictional receipt a false attribution of expenditure.[234]

The policy underlying the decision was best expressed by the accompanying opinion announced by Lord Radcliffe in his conclusionary remarks:

> In a situation where everything is to some extent fictitious, I think that we should prefer the third alternative of entering as a receipt a figure equivalent to the current realizable value of the stock item transferred. In other words, I think that the case of *Watson Bros. v. Hornby* was rightly decided and that its principle is applicable to all those cases in which the income tax system requires that part of a taxpayer's activities should be isolated and treated as a self-contained trade. The realizable value figure is neither more nor less "real" than the cost figure, and in my opinion it is to be preferred, for two reasons. First, it gives a fairer measure of assessable trading profit as between one taxpayer and another, for it eliminates variations which are due to no other cause than any one taxpayer's decision as to what proportion of his total product he will supply to himself. A formula which achieves this makes for a more equitable distribution of the burden of tax, and is to be preferred on that account. Secondly, it seems to me better economics to credit the trading owner with the current realizable value of any stock which he has chosen to dispose of without commercial disposal than to credit him with an amount equivalent to the accumulated expenses in respect of that stock. In that sense, the trader's choice is itself the receipt, in that he appropriates value to himself or his donee direct instead of adopting the alternative method of a commercial sale and subsequent appropriation of the proceeds.[235]

---

234. *Id.*

235. *Id.* at 84-85 (citations omitted).

2. *Conversion of Stock in Trade from Business to Personal Use: The American Experience*

American law also recognizes the unique problems associated with the conversion of stock in trade from business use to personal use. American law does not, however, have a leading case that provides a comprehensive approach to problems in this area. Instead, American law is revealed by examining many authorities offering a patchwork of different theories and approaches.

One should note the previous discussion outlining the various laws' approach to the "transfer" of stock in trade between businesses directly owned by the same taxpayer. Under both the British and American systems, such an event is treated as a notional sale for value. Whereas British law follows this approach for conversions between personal and business uses, American law does not. One might speculate that American courts simply missed the point of *Burgess Poultry*.[236]

The unstated starting point under American law is that realization is absent where property is converted from business to personal use. Thus, there is no true taxable event. The focus of the remedy is not on properly reflecting business income, or properly taxing business income, but instead on the propriety of business deductions. Thus, within this general framework, there are many theories that inevitably lead to considerable variation in approach.

Consider the conversion of stock in trade to personal use, which happens when the taxpayer appropriates the stock for his own personal use, or makes a donative transfer in a non-business context. Initially, the Service argued that the value of stock of a business, when converted to personal use, should be considered income to the owner-taxpayer. One of the earliest cases raising this issue was *Morris v. Commissioner*,[237] which concerned the assessment of taxes during one of the first years of the income tax law in the United States. In *Morris*, the court considered whether the value of farm products that the owner consumed should be considered as compensation for purposes of an otherwise allowable deduction for excess profit tax.[238] The court rejected the Service's argument, concluding that the inescapable and incorrect result of the Service's argument was that the value of the goods were income to the farmer:

---

236. *See supra* notes 205-16 and accompanying text (discussing *Burgess Poultry*).

237. 9 B.T.A. 1273 (1928).

238. *See id.* at 1277-78. If the taxpayer had invested capital in his business, he could deduct an amount equal to his salary, or compensation for his services in the business, for purposes of the excess profits tax. *See id.*

> To include the value of such products, even if it could be determined, in the deduction allowable for excess-profits-tax purposes to a farmer as compensation would automatically subject such amounts to normal tax and in effect include in income something which Congress did not intend should be so regarded. If products of a farm consumed thereon are income to the producer, it would seem to follow that the rental value of the farmer's home, the gratuitous services of his wife and children, and the value of the power derived from draft animals owned by the farmer and used without cost should also be so considered. It is obvious that such items are comparable to the rental value of a private residence, which has never been regarded as income or as a factor in the determination of tax liability.[239]

The Service's theory slumbered until the 1940s when it placed renewed hope in the United States Supreme Court's decision in *Helvering v. Horst*,[240] one of the leading cases in establishing the American doctrine of assignment of income. Relying on *Horst*, the Service adopted the position that the gratuitous transfer of business property, and hence its conversion to non-business use, should result in the inclusion of the fair market value of the property in the donor's income.[241] The Service's position applied both to personal gifts to individuals of business property and charitable gifts of business property.

Nevertheless, cases quickly followed rejecting the Service's argument. *Farrier v. Commissioner*[242] dealt with a personal gift of cattle held for business.[243] In *SoRelle v. Commissioner*,[244] the Commissioner attempted to tax the value of a mature wheat crop that had been conveyed as part of an overall gift of land to the taxpayer-donor's children.[245] Two cases also raised this issue in the charitable donation context. *White v. Brodrick*[246] considered a donation of wheat raised by the taxpayers.[247] *Campbell v. Prothro*[248] dealt with the donation of livestock (calves) to a charity.[249]

239. *Id.* at 1278. As can be seen, taxation herein might implicate imputed income—something that has never been taxed in the United States.

240. 311 U.S. 112, 117 (1940) (holding that the right to collect interest (on bonds retained by the taxpayer) gratuitously transferred to his son was taxable to the father when the son received the interest.

241. *See* I.T. 3910, 1948-1 C.B. 15.

242. 15 T.C. 277 (1950).

243. *See id.* at 283-84 (rejecting an application of *Horst*, finding no realized income).

244. 22 T.C. 459 (1954).

245. *See id.* at 475-76.

246. 104 F. Supp. 213 (D. Kan. 1952).

247. *See id.* at 214-15 (finding that in donating wheat, the taxpayer did not realize income or gain).

248. 209 F.2d 331 (5th Cir. 1954).

249. *See id.* at 332, 336 (finding the donation a gift and thus not subject to tax) .

These latter cases presented the additional wrinkle that, under United States law, the taxpayer is entitled to a deduction of the fair market value of the property donated to charitable organizations.[250] Irrespective of the context, the courts uniformly rejected the Service's arguments and concluded that no taxable income arose on the gift of property.[251]

Though the courts were not particularly clear, there are two possible theories for this result. The first is a common-sense view that there is no gain when nothing is had in return. The Service's argument, similar to that adopted in *Sharkey*, was that taxpayers do profit by giving the property away. It argued, "The products of a farm are, from the beginning, in the nature of income . . . and it is believed that the satisfaction derived from a contribution of such property to [a qualified organization] results in the enjoyment of income within the rule established in *Helvering v. Paul Horst R.G.*"[252] Similarly, a gift to a relative would result in enjoyment of the income. An even stronger case for enjoyment of income would result where no gift was made and the property was converted from business to personal consumption.

The difficulty the Service faced was that it made a revolutionary argument in the context of a donative transfer, a transaction not generally recognized as producing income. In the 1894 Act, United States tax law flirted with the concept that the value of gifts was income to the recipient.[253] Congress, however, quickly abandoned this approach in the 1913 Act by excluding the value of all gifts of property from income.[254]

The question before the courts was not whether the recipient of property had income, but whether the donor had income upon the disposition of the property by way of gift. Interestingly, the Internal Revenue Code (Code) has no specific provision that deals with the tax effect of a gift on the donor. The courts embraced the notion that one cannot have income where one does not get anything tangible in exchange for one's property. The courts simply would not accept the Service's view that generosity is

250. *See id.* at 333; *White*, 104 F. Supp. at 215.

251. *See Prothro*, 209 F.2d at 336; *White*, 104 F. Supp. at 215.

252. I.T. 3910, 1948-1 C.B. 15, 16.

253. *See* Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. 509, 553 (codified as amended at I.R.C. § 102 (1994)).

254. *See* Act of Oct. 3, 1913, ch. 16, 38 Stat. 114 (codified as amended at I.R.C. §§ 1-9722 (1994)); *see also supra* note 61. Congress subsequently limited the scope of this exclusion when it provided that the gifts and inheritances provisions did not apply to employer-employee gifts. *See* I.R.C. § 102(c) (1994).

its own reward capable of being valued. Key to their decision was the conclusion that no income had been realized.[255]

It is instructive to examine traditional notions of realization as they apply to the foregoing facts. First, there are no market transactions confirming the value of the property. In the case of charitable contributions, however, market value must be found for purposes of allowing a deduction. Second, in the case of personal gifts and conversion to personal use, the event does not produce the funds with which the tax can be paid. In the case of charitable gifts, however, any possible income would be completely offset by the deduction. Third, the asset can change value and thus the gain to the taxpayer is uncertain in the case of conversion to personal use. With respect to gifts, however, the investment in the property terminates for the donor, so that uncertainty has been removed.

After several losses, the Service abandoned its attempts to treat the transaction as a notional sale for value. Still concerned with the potential for tax abuse inherent in such transactions, the Service changed its strategy and refocused its attention on the taxpayer's prior deductions with regard to converted property. In Revenue Ruling 55-138,[256] the Service provided that gross income does not include the value of farm products, manufactured products, or property held for sale in the ordinary course of business that was donated to a charity.[257] Instead, the Service ruled that the taxpayer was required to remove the cost of these items from inventory.[258] Any deductions relating to these items not included in inventory costs must also be recovered.[259] In the case of expenditures made in the year of the donation, costs were to be recovered by disallowance of the deduction, or in the case of previous years' deductions, by reducing the charitable contribution deduction by that amount.[260]

Revenue Ruling 55-531[261] provided a slightly different rule for the donor in the case of a personal gift of business property. In the case of personal gifts, any deductible expenses relating to the gifted property arising in the year of transfer would not be allowed.[262] Furthermore, to the extent that prior years' expenditures associated with the gifted property were included in inventory costs, then such costs had to be removed

255. *See Prothro*, 209 F.2d at 334-35. Interestingly, it was only one year later that the House of Lords in *Sharkey* held that such a transfer *did* create a taxable event. *See* Sharkey v. Wernher, 1956 App. Cas. 58, 69 (appeal taken from C.A.).
256. Rev. Rul. 55-138, 1955-1 C.B. 223.
257. *See id.* at 225-26.
258. *See id.* at 226.
259. *See id.*
260. *See id.*
261. 1955-2 C.B. 520.
262. *See id.*

from purchases for purposes of applying inventory accounting.[263] Unlike the case of a charitable contribution, however, any previously deducted amounts relating to personally gifted property were left without adjustment.[264]

Revenue Rulings 55-138 and 55-531 represented the Service's new position in reaction to its unsuccessful attempt to treat gifts of business property as notional sales for fair market value. Rounding out the picture, we must also consider the Service's position on conversion of business property to the personal use of the taxpayer. In the Internal Revenue Manual, the Service instructs its revenue agents as follows: Determine if the owners consume or withdraw merchandise for personal use, such as food, clothing, appliances, building materials, boats, motors, etc. If so, proper reductions should be made to purchases or cost of sales.[265] It is apparent that this approach leaves out adjustments for deducted expenditures from prior years, and deductible expenditures made during the year of conversion. Although the Manual ignores such expenditures, the logic of Revenue Ruling 55-531 would suggest that otherwise deductible amounts related to the converted property, incurred in the year of conversion, would also be denied.

The scope of the Service's position outlined above is somewhat limited. All statements deal with inventory accounted for under an inventory method of accounting, with no indication that the doctrine extends beyond that kind of business property. In the United Kingdom, the principles of *Sharkey* apply to all kinds of trade assets and personal assets.[266]

Under American law, the question of whether goods must be accounted for under an inventory method of accounting is critical under the Service pronouncements. The cost of converted property is removed from inventory, resulting in the disallowance of any deduction from business income for those costs. If converted goods were included in inventory, removing the costs of those goods from inventory substantially limits any tax advantage derived from converting the property. If significant indirect costs associated with such inventory were deducted in prior years, however, an incentive to convert still exists. A few examples of such significant costs are purchasing costs, handling costs, storage costs, interest, and depreciation on equipment used to produce the property.

263. *See id.*

264. *See id.*

265. STEVEN R. ROBERTSON & KARL M. ROBERTSON, INTERNAL REVENUE MANUAL, 30 (Practioners Ed. 1992).

266. There is, however, a limit to the scope of the British doctrine in the case of professions. *See infra* text accompanying notes 337-40.

Under current United States law, some taxpayers are subject to the § 263A Uniform Capitalization Rules, which require that indirect costs associated with produced property, or property purchased for resale, be included in the cost of purchases for inventory accounting purposes.[267] Thus, where the Uniform Capitalization Rules apply, the costs associated with converted property will generally not be deductible. There are, however, some major exceptions to the reach of these rules. Section 263A does not apply to property purchased for resale where the taxpayer's gross receipts do not exceed ten million dollars.[268] Section 263A does not apply to the timber or ornamental tree business or to certain small farming operations.[269] In addition, § 263A does not apply to many expenses incurred in the development of oil and gas wells or other mineral property.[270] Thus, taxpayers not subject to the Uniform Capitalization Rules may deduct substantial indirect costs associated with converted property that will not be recaptured in later years.

In some cases, stock in trade of a taxpayer is also not subject to special inventory accounting methods. For example, an inventory method is required where inventory is a material income producing feature of a business.[271] Businesses engaged in providing services are generally not required to use inventories for goods sold to customers. Many farmers are permitted to use cash basis accounting; indeed, even accrual basis farmers do not have to inventory growing crops, trees, and plants.[272] Thus, it is clear that there is a considerable gap in the treatment of stock in trade where neither the Uniform Capitalization Rules, nor the Inventory Accounting Rules, apply. The gap may be particularly wide in the case of smaller business entities.

---

267. *See* I.R.C. § 263A (1994). Even when the property may not be subject to inventory accounting rules, the indirect costs of self-produced property and property purchased for resale must be capitalized when § 263A applies. *See id.* § 263A(a)(1)(B).

268. *See id.* § 263A(b)(2)(B).

269. *See id.* § 263A(c)(5) (stating that the provision does not apply to timber and ornamental trees produced by the taxpayer in a farming business); *id.* § 263A(d)(1)-(2) (stating that the provision does not apply to a farming business involving animals or plants having a preproductive period of two years or less, or to plants lost by reason of casualty, such as freezing temperatures, disease, drought, or pests); *see also id.* § 447 (requiring certain corporations engaged in the farming business to employ the accrual method of accounting).

270. *See id.* § 263A(c)(3).

271. *See id.* § 471; Treas. Reg. § 1.471-1 (1958) (requiring taxpayers to use an inventory method of accounting where inventory is an income producing factor of the business). A consequence of having to use an inventory method is that the taxpayer must use the accrual method for the business in general, as opposed to the cash method. Inventory is defined as stock in trade held primarily for sale to customers in the ordinary course of business.

272. *See* I.R.C. § 447(g); Rev. Rul. 79-102, 1979-1 C.B. 184.

When an expenditure with respect to stock in trade is not reflected in an inventory account because either the taxpayer was not required to use inventories, or that particular expense was not required to be included as a cost for inventory purposes, the consequences will depend on the particular situation. In Revenue Ruling 55-138, when the conversion was the result of a charitable contribution of property, year of conversion expenditures not in inventory were denied and previous years' deductions reduced the amount of the current year's charitable deduction. In Revenue Ruling 55-531, however, only current year expenditures were disallowed in the case of personal gifts. Previous years' deductions were not considered.

The Service never indicated the theoretical basis for its position, other than to say that when goods are removed from a business, the cost of such goods must be removed from inventory in order to counterbalance the loss of revenue occasioned by the withdrawal of the asset. It is likely that the justification for this approach probably lies in the Secretary's power to insist that the taxpayer's accounting method "clearly reflect income."[273] Income of the taxpayer would not be clearly reflected where cost of goods sold (a reduction in arriving at gross income) determined at the end of the taxable year after the conversion had taken place, included a cost associated with property that was not "sold" or disposed of in the course of the trade or business.

The Service's rule for expenditures that would be subject to rules of deduction is based on two tenets of American tax law: (1) an expenditure is not deductible unless it is for a profit-making activity; and (2) a determination to the contrary before the end of the taxable year requires that an adjustment be made. Thus, even though the expenditure was for stock in trade when made, at year end, we know that the expenditure was not for stock in trade but for non-business purposes.

Turning to expenditures deducted in prior years, the Service ignored these issues except in the case of charitable contributions. This was understandable for several reasons. First, one way of rectifying the problem would have been to open the prior years, deny the deductions, and assess deficiencies in tax. The Service, however, does not have the authority to do so because the doctrine of the integrity of the taxable year permits previous years to be opened for error only.[274]

A second approach would have been to counterbalance the previous year's deductions by an equal amount of income assessed in the year the

273. I.R.C. § 446(b).

274. *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364-67 (1931) (emphasizing the familiarity and importance of the annual tax system).

property was converted to non-business use. This, of course, is the method prescribed by the tax benefit rule, which offsets the benefit of a previous deduction by later inclusions in income.[275] Until recent times,[276] however, it was thought that the triggering event for the application of the tax benefit rule was the recovery of an item for which a previous deduction was taken. Under conventional wisdom, in the case of a gift or conversion to personal use, the taxpayer has neither received nor recovered anything; therefore, the tax benefit doctrine's rule of inclusion would not have applied.

In Revenue Ruling 55-138, the Service might have deemed the charitable contribution deduction a recovery of sorts, because in that case the charitable deduction was reduced for expenditures relating to the donated property deducted in prior years. One might say that there was a deemed recovery when the taxpayer enjoyed the value of the property, for tax purposes, by disposing of it in such a manner as to enjoy a deduction for the fair market value of the property.[277] The Revenue Ruling result is based instead, however, on the principle that a taxpayer should not get a double benefit for the same item, that is, a deduction for a cost of acquisition plus a deduction for the value donated.[278] This conclusion is not justified on the basis of the tax benefit rule because that rule is founded on the principle that the previous deduction proves unwarranted in hindsight.

Does the tax benefit rule apply to these situations, that is, to the disposition of stock in trade by personal gift or the conversion of stock in trade to personal use? Modern principles indicate that it does.

---

275. *See* I.R.C. § 111; Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 401-02 (Ct. Cl. 1967) (applying the tax-benefit rule in a case involving recovered realty where the taxpayer received full benefits from a charitable contribution deduction).

276. *See infra* text accompanying notes 278-305 (discussing *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983)).

277. The Service and the courts also have found a taxable event, or deemed realization, in a situation where a teacher makes a charitable contribution of complementary copies of books received from a publisher. *See* Haverly v. United States, 513 F.2d 224, 226 (7th Cir. 1975). The receipt of the books from the publisher is not an income-producing event, but upon donation, the taxpayer has income to the extent of the fair market value of the books. *See id.* This inclusion is equivalent to the amount of the charitable deduction, thus removing the tax benefit from such a contribution. *See id.* at 227; Rev. Rul. 70-498, 1970-2 C.B. 6 (providing that when a book reviewer, under the employment of a newspaper, receives unsolicited books, donates such books to a charity, and takes a deduction, the fair market value of the books is to be included in gross income).

278. The double benefit principle is also used to justify the view that the donation of complementary copies of books and other items provides income. *See supra* note 277. There the benefits were the noninclusion of the books in income in the year of receipt plus the allowance of their fair market value as a charitable contribution where there had never been a tax cost associated with the property.

The tax benefit rule has been expressed as follows: "a recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery."[279] There are several aspects of the rule that are important to emphasize. Traditionally, the rule arises where the taxpayer appropriately takes a deduction for an item in a particular taxable period, and after the close of the period the taxpayer recovers the item that was the basis for the deduction. The conclusion upon the recovery is that the previous deduction has proved to be "erroneous"; the Service, however, cannot go back to the year of the deduction and correct the error because the deduction, when taken, was correct. The doctrine of the "integrity of the taxable year" prevents the Service from opening a previous year to correct an item that was correct at the time.[280] The remedy is to include the recovered item in the current period up to the extent of the previous deduction.

A recovery is important because it is the "taxable" event that triggers the application of the tax benefit rule. It is also typically the taxpayer's subsequent receipt of the item that illustrates the unreasonableness of allowing the taxpayer to benefit from the prior deduction. The value of the recovery can also limit the possible inclusion. It should be understood, however, that the recovery is not income. Under traditional notions, the tax benefit rule works in situations that would not normally produce income because the taxpayer is simply getting back what was once his, and, hence, represents a non-taxable return of capital. It is the inconsistency of the prior deduction with the recovery that creates the need for an income adjustment offsetting the prior deduction.

Thus, in most cases the amount of the previous deduction is simply included in income, to the extent it produced an actual tax benefit.[281] This is easily accomplished when a taxpayer receives a refund of state income tax that had been deducted previously. The deduction is recaptured as income to the extent of the cash recovery. When the recovery is of specific property, however, the fair market value at recovery may be different than the fair market value at the time of the deduction. When the value has increased, the prior deduction represents the appropriate

279. Nash v. United States, 398 U.S. 1, 3 (1970).

280. The rationale was set forth in *Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60, 63 (7th Cir. 1940):

> Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs.

Id. at 341.

281. *See* I.R.C. § 111 (1994).

amount of inclusion.[282] But when the property has decreased in value, then the prior deduction is included only up to the amount of the current fair market value.[283]

The United States Supreme Court dispelled the view that there must be a recovery of a previously deducted item in order for the tax benefit rule to apply in *Hillsboro National Bank v. Commissioner*[284] and its companion case, *United States v. Bliss Dairy, Inc.*[285] In *Bliss Dairy, Inc.*, a company distributed cattle feed to shareholders in a corporate liquidation, the cost of which had been deducted in a previous year.[286] Though there was realization, that is, the corporation exchanged property for its own stock, the transaction was covered by a non-recognition provision of the Code, § 337.[287] The Court concluded that § 337 did not preclude the application of the tax benefit rule in this instance.[288] Section 337 was still free to work in its own particular way by leaving unrecognized the gain produced on the exchange of the feed for stock.[289] If treated as a fully taxable sale or exchange, the gain would have equaled the "amount realized" or "fair market value,"[290] which would have equaled the fair market value of the feed minus the basis of the feed, which would have been zero, because all costs associated with the acquisition of the feed had been deducted previously.

The Court concluded that an actual recovery was not required, finding that "unless a nonrecognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction."[291] The Court stressed that the later events must be "unforeseen at [the] time of the earlier deduction"[292] and "fundamentally

282. *See* Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 403 (Ct. Cl. 1967).

283. *See* Rosen v. Commissioner, 71 T.C. 226, 234 (1978), *aff'd*, 611 F.2d 942 (1st Cir. 1980). In *Rosen*, the taxpayer had taken a charitable contribution deduction in the amount of $48,000, the fair market value of the property at that time. *See id.* at 228. When returned in 1974, the property was worth only $25,000. *See id.* at 234. The taxpayer realized the fair market value of the recovered asset as determined at the time of the recovery. *See Rosen v. Commissioner*, 611 F.2d at 943.

284. 460 U.S. 370 (1983).

285. *See id.* (reporting the decision included in *Hillsboro*).

286. *See id.* at 374.

287. *See id.* at 401-02; I.R.C. § 337 (1994) (providing that no gain or loss is recognized for property distributed to a parent corporation from a complete liquidation of its subsidiary).

288. *See Hillsboro Nat'l Bank*, 460 U.S. at 402.

289. *See id.* at 401-02.

290. I.R.C. § 1001 (stating the process by which the amount realized from a sale or exchange of property is determined).

291. Hillsboro, 460 U.S. at 372.

292. *Id.* at 383.

inconsistent with the premise on which the [earlier] deduction was initially based."[293] In other words, "[i]f that event had occurred within the same taxable year, it would have foreclosed the deduction."[294]

The Court indicated that its understanding that a recovery was not necessary was in accord with prior law.[295] It principally relied on accrual accounting concepts. Under accrual accounting principles, a taxpayer is permitted to take a deduction when an obligation to make a payment arises, even though the item is not actually paid at that time. When, in a later tax year, it is determined that a taxpayer does not have to pay, accepted tax doctrine requires that the taxpayer take into income the amount of the expense previously deducted.[296] Since nothing is actually received, the Court reasoned that this situation did not fit within the ordinary definition of "recovery."[297] Accrual principles do not provide particularly strong support for the Court's ultimate conclusion, however. Though there is no recovery in the sense of an actual inflow of an amount that represents a previously deducted item, there is a clear recovery in the accrual accounting sense. Under accrual principles, it is the fixing of the obligation to pay, not the payment itself, that creates a taxable event, or a deductible expenditure. If the creation of an obligation to an accrual taxpayer is the same as an actual payment by a cash basis taxpayer, then the termination of the obligation to pay for the accrual basis taxpayer is the same as the actual return of the payment to the cash basis taxpayer.

Once the Court concluded that a recovery was not necessary, it illustrated its rationale by applying the results to a situation in which a taxpayer had converted a business asset to personal use.[298] The Court considered the situation in which a taxpayer makes a rental payment on December 15 for a business premises for a thirty day period. The payment is a current expenditure and deductible on the day made.[299] On January 1, the first day of the following taxable year, the taxpayer's family moves in, thus converting the premises to personal use.[300] The Court concluded that this would be an event fundamentally inconsistent with the business use upon which the deduction was based.[301] Therefore, the

293. *Id.*
294. *Id.* at 383-84.
295. *See id.* at 381-82.
296. *See id.*
297. *Id.* at 382.
298. *See id.* at 384-85.
299. *See id.*
300. *See id.* at 385.
301. *See id.*

tax benefit rule would require the inclusion in the taxpayer's income of a sum representing the amount paid for January.[302]

Here, there is no recovery and no realization in the classic sense. There is no realization under American law of the value of the asset because the taxpayer neither exchanges the asset nor receives anything of value. When a taxpayer converts property to personal use, the Service may not properly tax economic gain or loss, but must await an exchange for value. The basis or tax cost of the item remains the same, and in the case of expensed property the basis would be zero. Gain may be reported if the taxpayer disposes of the asset in a taxable transaction.

The Court, however, had difficulty with this traditional outcome. If the taxpayer may consume the value, the gain is not simply postponed, but lost. In the case of the rental payment considered above, this clearly would have been the result. In the United States, this result is inevitable because the benefit derived from the consumption of the use value of one's own property is not taxable income. This benefit is called imputed income.[303] In the typical case of a taxpayer consuming his or her own property, the taxpayer consumes his or her own capital (the purchase price) as well as any potential gain, both in an economic sense and a tax sense. This, though, is not the case where property is converted to personal use. Where a taxpayer previously deducted the cost of converted property, the taxpayer is not consuming his or her own capital in a tax sense, but only potential taxable income. Thus, as a practical resolution, the Court's treatment of the previous deduction as income, under the tax benefit rule, goes a long way toward putting the taxpayer in the position he or she would have been in if he or she had originally purchased the item for personal use. But this is not always the case. Deductible expenses that were not part of the acquisition costs may not be recaptured. Also, where the property has dropped in value while held by the taxpayer for business purposes, the recaptured deduction will be included only to the extent of the present fair market value of the property.[304] Thus, where a loss in value occurs during business ownership, that loss is allowed for tax purposes.[305] Where a gain occurs during business ownership, that gain is not realized and may be lost to the system through

302. *See id.*

303. *See* CHIRELSTEIN, *supra* note 188, at 23 (discussing imputed income).

304. This is the traditional rule. The logic of *Hillsboro* might indicate that the proper outcome would be the full inclusion of the prior deduction because the tax benefit rule is based on the assumption that *any* prior deduction has proven, in hindsight, to be unwarranted.

305. Economic analysis would show that the loss should be allowed because it was incurred while the property was held for business. Full implementation of an economic analysis, however, requires full taxation, not simply the application of the tax benefit rule.

taxpayer consumption. Application of the tax benefit rule to conversions thus eliminates part, but not all, of the problem caused by conversion.

The application of *Hillsboro* presents vast unknowns. The Court cautioned that it was not deciding whether the tax benefit rule applied where expensed assets were disposed of by gift or devise.[306] Since both gift and devise situations present the same problems as simple conversions to personal use, that is, the problem of previously expensed assets escaping taxation, the tax benefit rule should apply. A gift or devise of business property is certainly inconsistent with the purpose for which the property was acquired.

A second unknown deals with how far this doctrine will extend to prior deductions. *Hillsboro* spoke of the application of the doctrine to the direct costs of both tangible (cattle feed) and intangible (prepaid rent) assets. What about indirect costs and carrying charges?

The United States Tax Court has found that there is a limitation. In *Rojas v. Commissioner*,[307] the Service sought the inclusion of previously deducted expenses for materials and supplies that had been expended to produce crops distributed to shareholders pursuant to a corporate liquidation.[308] The court concluded that the deductions could not be recaptured because they had in fact been consumed in the business, even though the crops they produced were not.[309] This view, in essence, would preclude the application of the tax benefit rule to the direct costs of self-produced assets. Fortunately, most self-produced assets, except in farming activities, would normally be treated under an inventory method of accounting subject to the Uniform Capitalization Rules, which makes the operation of the tax benefit rule largely superfluous. The logic of *Rojas* also indicates that the tax benefit rule does not apply to indirect costs. Moreover, *Rojas* dealt with expenditures that had been deducted (or were being deducted) in the year of conversion. The result calls into question the provisions of Revenue Ruling 55-531,[310] which denies a current deduction in a case where farm animals or produce were converted by way of personal gift. There the Service ruled that, "If, for example, the products or goods were grown or manufactured in the year of the gift, such cost applicable thereto should be disallowed."[311]

306. *See Hillsboro Nat'l Bank*, 460 U.S. at 386 n.20.
307. 90 T.C. 1090 (1988), *aff'd*, 901 F.2d 810 (9th Cir. 1990).
308. *See id.* at 1091-92.
309. *See id.* at 1109.
310. Rev. Rul. 55-531, 1955-2 C.B. 520, *modified*, Rev. Rul. 75-11, 1975-1 C.B. 27.
311. *Id.* at 522.

3. *Depreciable or Wasting Assets*

When dealing with the conversion of depreciable property used in a trade or business to a nonbusiness use, British and American law provide their most polar results. Consistent with the principles of *Sharkey v. Wernher*,[312] British law treats the taxpayer as having made a notional sale at an open market price in the course of trade. Instead of recognizing the gain, British legislation requires a balancing charge, in which depreciation deductions for the year are reduced by the amount of the gain.[313] The consistent and logical outcome under the Taxation of Chargeable Gains Act is that a person who has taken a depreciable asset out of trade is treated as having been paid the open market price.[314] Thus, British law continues to follow the principle that, regardless of whether the notional sale of the asset produces gain or loss, the business accounts must reflect the actual economic result that occurred during the time the business held the asset.

American law has a narrower objective. The primary purpose of the statutory depreciation recapture rules is to ensure that the gain from the disposition of depreciable assets is ordinary income, not capital gain, to the extent that such gain represents prior depreciation deductions.[315] This is necessary in the United States because capital gains and losses are one facet of the overall income tax scheme, and depreciable business property is otherwise treated much like a capital asset under § 1231.[316]

The recapture rules also contain provisions suspending the operation of certain nonrecognition rules.[317] The Code, however, specifically excludes dispositions by way of gift or devise from depreciation recapture.[318] As noted before, gifts and devises are not considered taxable dispositions under American law due to questions of gain and realization, not nonrec-

312. 1956 App. Cas. 58 (appeal taken from C.A.).

313. *See* Capital Allowances Act, 1990, ch. 1, §§ 4, 24-26 (Eng.).

314. *See* Taxation of Chargeable Gains Act, 1992, ch. 12, § 17 (Eng.).

315. *See* I.R.C. § 1245(a)(1) (1994) (classifying "[g]ain from dispositions of certain depreciable property" as generally ordinary income); *id.* § 1250(a)(1) (including "[g]ain from dispositions of certain depreciable realty" as generally ordinary income). For real property, recapture applies only to the excess of accelerated depreciation over straight line. *See, e.g.*, *id.* § 1250(b)(1).

316. *See id.* § 1231 (addressing gains and losses in the context of property in a trade or business and also involuntary conversions).

317. *See id.* §§ 1245(a), 1250(a). Under general principles of U.S. tax law, all realized gains are recognized (included in income) unless a specific nonrecognition section of the Code provides otherwise. *See id.* § 1001(c) (providing that "[e]xcept as otherwise provided [in the code], the entire amount of the gain or loss . . . on the sale or exchange of property shall be recognized").

318. *See id.* §§ 1245(b)(1), (2), 1250(d)(1),(2).

ognition.[319] Conversions to personal use are not specifically mentioned in those sections, most likely because such changes in use have never been considered a disposition.

4. *Change of Purpose: Personal to Business*

What happens to a taxpayer who converts a personal use asset to business use? For example, a taxpayer purchased an automobile for personal use. Years later, she decides to devote this automobile exclusively to a business purpose. Uniformly, whether we consider British or American tax law, deductions are not allowed for maintenance, repair, or depreciation of assets devoted to personal use. When an asset is a wasting asset, there is a good chance that its value will have decreased since the time it was originally acquired for personal use. This lost value represents value that has been consumed through personal use. Neither the United Kingdom nor the United States system allows a deduction for a loss on the disposition of a personal use asset. Where there is conversion of a personal use asset to trade or business use, there is no actual disposition. Thus, such a conversion presents the possibility that the taxpayer could use the original cost of the asset for business purposes, thus taking deductions for amounts that actually represent personal consumption. Both systems prevent this possibility, but by quite different devices.

a. *The United Kingdom: Personal to Trade*

Sharkey v. Wernher[320] is known for the well-recognized principle of British tax law that the conversion of stock in trade to personal use is a taxable event treated as a disposition for value. Viscount Simonds's comments on the proper treatment of conversions of property from personal use to use in a trade are an equally important facet of this case. Viscount Simonds concluded that the general principles of *Sharkey* apply to this transfer as well:

> In the same way, it would, I suppose, be claimed that, if Lady [Wernher] were to transfer or re-transfer a horse from her racing establishment to her stud farm, some figure would have to appear in the stud farm accounts in respect of that horse, though it cost her nothing to make the transfer: if it were not so and she subsequently sold the transferred horse and the proceeds of sale were treated as receipts of the stud farm, she could justly complain that she had been charged with a fictitious profit.[321]

319. *See supra* notes 250-52 and accompanying text.
320. 1956 App. Cas. 58 (appeal taken from C.A.).
321. *Id.* at 72.

Thus, the transfer of a horse from a racing activity (considered personal in the United Kingdom) to a stud farm (considered a trade) creates a taxable event that also should be treated as a notional sale at market value. Such treatment is entirely consistent with the holding of the case. Although Lady Wernher lost the case, the overall implications were probably beneficial to her, because any gain or loss due to the disposition of personal use property would have been capital. For most of its history, the United Kingdom did not tax income from the sale of capital assets. Thus, any appreciation in value of the horses due to their successful racing careers would have escaped taxation. Any loss, of course, would also have been ignored. Both the dicta and holding of *Sharkey* require that transfer of assets from personal to business use be treated as a sale at open market value. Thus, a taxable event is once again created. Under the facts of *Sharkey*, however, any gain or loss would now be subject to the Taxation of Chargeable Gains Act, not the normal income tax.

As noted previously, the capital gains provisions today treat capital gains as ordinary income under most circumstances.[322] There are, however, some major exclusions. Any gains derived from the sale of wasting assets, defined as those assets with a predictable life not exceeding fifty years,[323] are exempt from tax in the United Kingdom.[324] Horses would certainly qualify for this exclusion. Any loss derived from the sale of wasting assets would be denied also.[325] To complete the picture, if the asset were not a wasting asset, the capital gains provisions also have a general chattel exemption that exempts the gain from the sale when the total consideration does not exceed six thousand pounds.[326]

The rationale for the tax exemption for wasting assets appears to be that wasting personal use assets typically decline in value, so that gain rarely would be produced.[327] Obviously, not all personal use assets, such as race horses, would decline in value, resulting in some large capital gains escaping taxation under this rule. Since Lady Wernher's stud farm appropriated the animals with a notional market value purchase price,

322. *See supra* notes 148-67 and accompanying text (comparing the treatment of capital gains and losses under the English and American systems).

323. *See* Taxation of Chargeable Gains Act, 1992, ch. 12, § 44 (Eng.).

324. *See id.* § 45. This exclusion does not apply to business assets that have been used as such since the beginning of ownership to the assets' disposal. *See id.* § 47.

325. *See id.* § 16(2) (providing that losses are not allowed to the extent that gains from the same transactions would not have been taxed).

326. *See id.* § 262(1). For sales at total consideration greater than £6000, the Act contains a phaseout provision. *See id.* § 262(2), (5).

327. Under British tax principles, real properties used as residences are not wasting assets. *See* Taxation of Chargeable Gains Act § 44(1)(a).

the stud farm would have been able to deduct that cost over the useful life of the animal.[328]

When the asset involved is not a wasting asset, the disposition is typically subject to taxation under the capital gains provisions. When an asset is converted to stock in trade, § 161 specifically defines the transaction as a notional sale at market value.[329] Subsection (3) of § 161 allows the taxpayer to escape capital gains tax consequences in this context in two ways: (1) by reducing market value cost for purposes of the trade by the amount of the chargeable gain; or (2) by increasing market value cost for purposes of the trade by the amount of the allowable loss.[330]

Echoing the words of Lord Radcliff, this method presents a fairer measure of taxation than the other methods suggested to the Court.[331] It ensures that the trade takes into consideration the actual profit or loss experienced after conversion to business use. It also ensures that the appreciation in value (or gain) or depreciation in value (or loss) that the taxpayer actually experienced while holding (and using) the property for personal pursuits is taken into consideration as the particular system mandates. Lastly, the method ensures that the profits of the stud farm properly reflect the actual costs it incurred in making a profit. It is the horse's value, which has been determined in a taxable event, that is used or consumed by the trade in making a profit.

The provisions do allow for the distinct possibility that the business taxpayer will be able to write off amounts that represent untaxed gain. This, however, is an explicit feature of the Taxation of Chargeable Gains Act that allows, in certain circumstances, a gain on the sale of property to escape taxation.

b. *The United States: Personal to Profit-Making*

The taxpayer's change of use of property under American law, in this case from personal to business, is not a taxable disposition.[332] If it were, gain would be taxed, subject to the application of special rates for some

---

328. *See* CCH British Tax Reporter, ¶ 358-650 (1989).

329. *See* Taxation of Chargeable Gains Act § 161 (1).

330. *See id.* § 161(3).

331. *See* Sharkey v. Wernher, 1956 App. Cas. 58, 84-85 (appeal taken from C.A.) (Lord Radcliff, J., concurring).

332. The following discussion applies to all profit-making activities, including trades and businesses (or professions), investments, and employment.

capital gains;[333] losses would not be allowed since losses are generally not allowed on the disposition of personal use property.[334]

Since there is no sale or other disposition, American law must deal with this situation in another manner. Instead of dealing with all possibilities, American law focuses on a particular abuse caused by the conversion. This abuse occurs when the property has lost value during personal use, as when the property's fair market value is less than the property's cost or "adjusted basis." American law prevents this economic personal loss from being deducted as a business loss by a rule that limits the taxpayer's adjusted basis to the fair market value of the property at the time of the conversion for purposes of loss deductions and depreciation only.[335] This special rule does not affect a later disposition at a profit; thus, the taxpayer must keep two basis accounts, one for purposes of sale at a gain and one for purposes of deductible loss and depreciation.

American law ignores the case in which property has increased in value over basis during the time of personal use. The economic gain is simply deferred. Cost or basis for purposes of the business remains the taxpayer's historic cost, not the increased fair market value at the time of the conversion. There is a trade-off between immediate recognition of gain (and revenue to the government) and lesser business deductions caused by the failure of the cost or basis for the business to increase to fair market value. This introduces a trade-off which may counter deferral: the non-taxation of capital gains at a maximum rate versus the disallowance of future ordinary business deductions at the taxpayer's highest marginal rate.

5. Sharkey v. Wernher *Limited*

One British court has ruled that the principles of *Sharkey v. Wernher*[336] do not apply in the case of a taxpayer, in a profession, who disposed of self-created property. In *Mason v. Innes*,[337] Judge Goff ruled that no no-

333. *See* I.R.C. § 1(h) (1994) (discussing maximum capital gains rate).

334. *See id.* § 165(a), (c)(1), (2) (limiting deductions for losses to losses incurred in trade or business, or transactions engaged in for profit). Certain casualty losses to personal use property are allowed. *See id.* § 165(c)(3).

335. *See* Heiner v. Tindle, 276 U.S. 582, 586 (1928) (analogizing to gifts of devise and finding the true fair market value "at the time when the transaction for profit was entered into may be taken as the basis for computing the loss"); *see also* Treas. Reg. §§ 1.165-9(b)(2), 1.167(g)-1 (1995). The theory of the case is that losses are allowed only when incurred in a "transaction entered into for profit." I.R.C. § 165(c)(2); *see Tindle*, 276 U.S. at 585 (interpreting the phrase broadly). Personal losses are not allowed. *See* I.R.C. § 262(a).

336. 1956 App. Cas. 58 (appeal taken from C.A.).

337. 1967 1 Ch. 436, *aff'd*, 1967 Ch. 1079 (Ch. App.).

tional sale for value existed when an author gave his unpublished novel to his father.[338] The taxpayer was in a profession, and had previously deducted costs associated with writing the novel.[339]

Judge Goff's decision rested on the assumption that the novel essentially represented the taxpayer's services. Taxing in this instance would lead to the following anomalous result:

> [C]arried to its logical conclusion the principle, if applied to professional men, must mean that they cannot give their services within the ambit of their profession without, in some cases at least, becoming liable to income tax on notional fees, which in my judgment is a reductio ad absurdum.[340]

Certainly, the British system is not alone in its reticence to becoming involved with the transfer of services within the family. Consumption of one's own services, a form of imputed income, has not been the subject matter of tax. The gift of one's services is analogous to self-consumption; that is, instead of providing such services in a market transaction and getting paid for them, the taxpayer chooses to forego a cash benefit for the personal satisfaction of conferring a benefit on another. Neither system has found that this is a particularly proper or practical area for taxation.

Based on the fact that *Innes*, though not a decision of the House of Lords, has remained unchallenged for almost thirty years, it would be safe to conclude that British law is settled on the point that there are no tax consequences. Under American law, the tax benefit rule, as formulated in *Hillsboro*, might apply to include the previous deductions as income. *Hillsboro*, however, has not been used in this manner thus far. The situation is analogous to employees who use facilities or supplies to perform personal services for themselves. While the employers would normally receive a deduction, and the employees would be receiving economic benefits, these benefits are typically excluded from income as *de minimus* fringe benefits.[341] *Hillsboro*, therefore, may simply not apply, even though deductions have been taken for expenses, which now, in hindsight, are proven to be related to a personal activity.

Classic imputed income doctrine is a satisfactory approach when dealing with the transfer *en famille* of consumable services. Typically, these services are rendered in a situation other than the professional capacity of the donor. Consequently, there may not be a ready market or easily as-

338. *See id.* at 437-38, 448-49.
339. *See id.* at 437-38.
340. *Id.* at 448.
341. *See* I.R.C. § 132(e) (1994) (excluding from the employee's income the value of property or services that is "so small as to make accounting for it unreasonable or administratively impracticable").

certainable value for them. Deductions, moreover, would not have been taken by the donor. Imputed income doctrine is inappropriate, however, when substantial deductions have been taken, or when the service becomes a property interest capable of being sold by the donee for value. The tax system is wronged, at the least, in letting stand the deductions incurred by the donor in creating the property. The system is doubly wronged when the property is given away and the economic income is taxed to another.

From an American perspective, the real issue suggested by *Innes* is the application of the assignment of income doctrine. Income earned by the donor is received by the donee; should it not be taxed to the donor? A finding of a notional sale for market value would have taxed the donor fairly on the income generated in his profession at the time of the gift. This result would obviate the need to resort to the assignment of income doctrine.

The American assignment of income doctrine does not apply to the facts of this case. The doctrine is divided into two parts, one dealing with service income and one with property income. Self-created property is treated as property income. When a donative transfer of the entire property (corpus and income) is made, the new owner of the property is typically taxed on the income.[342] An exception exists when the donee cannot affect the amount of income the property earns. In that case, the income is taxed to the one who transferred the property.[343] Of some amusement is the fact that, in the United States, disposition of the novel by the author to his father is not covered by principles applicable to assignment of service income, which would tax the donor, because tax law treats the novel as property. In the United Kingdom, however, the transfer of the novel is not treated as a notional sale of property because it is treated as a transfer of services.

D. *Transfer Pricing and Realization*

In both nations, modern doctrines regarding dealings between related entities have been designed to cure what legislatures have concluded to be serious abuses of the tax system. An examination of the function of these doctrines may elucidate the most critical aspects of the doctrine of realization.

342. *See* Heim v. Fitzpatrick, 262 F.2d 887, 890 (2d Cir. 1959) (holding that the taxpayer did not retain sufficient control over property assigned by him to family members to justify treating him as the owner for tax purposes).

343. *See* Helvering v. Eubank, 311 U.S. 122, 123-24 (1940).

The statutes of both the United Kingdom and the United States respond to the situation when related parties are not dealing with each other at arm's length. British law is the narrower of the two. It addresses only sales of property,[344] and requires that the participants be "bod[ies] of persons."[345] Further, it applies only to buyers who are residents when the actual price is greater than an arm's-length price,[346] and to sellers who are residents when the actual price is less than an arm's-length price.[347]

American law, on the other hand, is broader in its coverage, dealing with both domestic and international situations.[348] American law covers all dealings, not just those involving property. Persons affected include "organizations, trades, or businesses (whether or not incorporated)."[349] Section 482 grants the Service the power to allocate income and deductions among affected persons when such power "is necessary in order to prevent evasion of taxes or clearly to reflect the income"[350] of such persons. Both nations' provisions adopt the arm's-length standard.[351]

The most typical situation covered by transfer pricing legislation concerns transactions between affiliated corporations. Consider transfers of property between such corporations. From the point of view of the total economic enterprise, the *firm*, nothing of substance has happened. There has been no disposition, no ending of the interest in the property, no true sale.[352] Yet, for most purposes,[353] transactions between affiliated corporations are treated as transactions between strangers. Indeed, transfer

344. *See* Income and Corporation Taxes Act, 1988, ch. 1, § 770(1) (Eng.). The procedure also applies to leases and transfers of intangibles in the same manner as it does to sales. *See id.* § 773(4).

345. *Id.* § 770(1).

346. *See id.* § 770(1), (2)(a).

347. *See id.* § 770(1), (2)(b).

348. *See* I.R.C. § 482 (1994). In practice, because invocation of § 482 is in the discretion of the Commissioner, the transfer pricing doctrine is utilized only to protect the United States tax base.

349. *Id.* One court has found that § 482 is applicable to an individual in the entertainment business and his wholly-owned corporate chicken business. *See* Borge v. Commissioner, 405 F.2d 673, 678 (2d Cir. 1968).

350. I.R.C. § 482.

351. *See* Income and Corporation Taxes Act, § 770(1)(b); Treas. Reg. § 1.482-1(b)(1) (1996).

352. *See* William B. Barker, *Federal Income Taxation and Captive Insurance*, 6 VA. TAX REV. 267, 299-300 (1986).

353. One exception to this in the United States is insurance contracts between one parent company and its own captive insurance company. *See, e.g.*, Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835, 840 (6th Cir. 1995); Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985); *see also* Barker, *supra* note 352, at 267.

pricing rules exist to ensure that related entities conduct themselves as if they were strangers.

Is realization present where goods are transferred at a price other than at arm's length? First, there is no market transfer that confirms the income. The selling corporation, when it has sold the goods for less than fair market value, does not receive the cash (representing some of the income) to pay the tax. Additionally, when one considers the difficulty often faced by government and taxpayer alike in establishing an arm's-length price, one can safely conclude that even when dealing with stock in trade, value can be difficult to determine. The gain or loss is also transitory when one focuses on the firm.

Tax law, of course, does not focus on the firm but on the individual corporate enterprises, which are separate taxpayers. Tax law in this area begins its analysis at a different point than economics. Thus, dealings among members of the same economic group represent, *for tax purposes*, real dispositions, real terminations of the corporation's investment, and real sales. From an economic point of view, these transactions are less real than gifts, and are no more real than the other transfers to or from trade discussed above. From a tax position, they are taxable dispositions for value.

The scope of § 482 is not limited, however, to corporate bodies. The statute covers unincorporated "organizations, trades, or businesses."[354] The section can apply to dealings between separate and distinct businesses of the same taxpayer like those found in the case of *Burgess Poultry*.[355] The tax construct of separate corporate entities that results in realization in the inter-company setting under § 482 is absent in these situations.

Moreover, principles parallel to transfer pricing doctrine apply as well to intra-business or intra-company dealings with international components under American law. Section 863(b),[356] and regulations thereunder,[357] require the apportionment or allocation of income (and deductions) for certain cross-border activities between United States source and foreign source income.[358] This is required to ensure that foreign source income is appropriately calculated for purposes of the limitation on the foreign tax credit.[359] Thus, the equivalent of a deemed realization

354. *See* I.R.C. § 482.
355. *See supra* note 349. For a discussion of *Burgess Poultry*, *see* notes 205-17.
356. *See* I.R.C. § 863(b).
357. *See* Treas. Reg. § 1.861-8(f)(3) (1977).
358. *See id.* § 1.861-8(f)(3)(A)-(C) (transportation, manufactured goods, and sales of personal property).
359. *See id.* § 1.861-8(f)(1)(i).

is adopted under American law for purposes of sourcing, though not for purposes of timing, of certain international intra-business activities.

E. Realization: Conflicting Doctrines and a Proposed Solution

Reflecting on the quite different approaches to the conversion or change of use of assets under the British and American systems, it is necessary to reiterate the surprising proposition that both systems consider the principle of realization a critical element in defining income. While the two countries have reached dramatically different results, it should be noted that the British decision was a difficult one. Indeed, it was on a knife's edge and, though it might not have been known to the drafters of the decisions, they were considering many of the same issues and important arguments raised in the United States. Is the conclusion to be reached from this comparison that realization is merely an arbitrary condition that takes its content from the character and policy objectives of a particular tax system? Or does the concept of realization in the definition of income contain core critical elements generally applicable to any income tax system?

Though both expressions provide some insight, the comparative analysis undertaken herein supports the conclusion that realization has pragmatic elements important to the definition of income for tax purposes. Moreover, critical assessment of each system's approach illuminates some of that essence. This analysis concludes that the British approach focuses directly on the critical core of this concept and is, in fact, the superior political tool for fair and common sense taxation.

Reconsider modern economic theory's rejection of realization as a component of the definition of economic income. If given a choice as to the best base for assessment, an assessment based on the lifetime earnings of a taxpayer would prevail. In such a case, the precise timing of income would be irrelevant. The results of transactions during life would be recorded as realized since that event would present the best evidence. Ultimately, the debate between accretion and realization-based systems would be irrelevant. Remaining assets would be valued at death, and the concerns of realization would generally be met because the taxpayer's investment would truly be at an end.[360]

360. First, gain or loss is no longer transitory to the decedent because his relation to the property is at an end. Second, property is typically valued at death for inheritance purposes and errors in valuation would be reflected in the recipient's tax cost or other basis. Third, the unfairness perceived when taxing unrealized appreciation due to the possibility that the taxpayer would not have independent funds to pay the tax and might be required to sell the property does not apply here because the taxpayer, at death, transfers the property in any event.

The inherent difficulty of tax policy is that it does not tax lifetime income, but the results of particular taxable years segmentally. The major purpose of tax law is to collect revenue, whereas the foci of economic analysis are different. Thus, tax law must allocate results to particular time periods. The concept of realization has been important in accomplishing that goal.[361] But what are the necessary attributes of this doctrine?

Realization, as an American tax concept, generally requires that income be made real or confirmed by a market transaction between separate taxpayers.[362] American tax law, however, will assess tax even where valuation of the consideration is incredibly difficult,[363] unless the value of what has been received is too inherently speculative.[364] One can assume

361. Is a realization-based system of taxation superior to an accretion-based system? This Article points out that the solution to this question is not simple because, though accretion taxation more closely complies with modern economic theory, tax law has different objectives. As one economist has stated:

> [M]ost economic controversies about definition arise from a failure to keep in mind the relation of every definition to the purpose for which it is to be used. We have to be prepared to use different definitions for different purposes; and although we can often save ourselves trouble by adopting compromises, which will do well enough for more than one purpose, we must always remember that compromises have the defects of compromises, and in fine analysis they will need qualification.

J.R. Hicks, *Maintaining Capital Intact: A Further Suggestion* (1942), *reprinted in* READINGS IN THE CONCEPT AND MEASUREMENT OF INCOME, at 145 (R.H. Parker et al. eds., Phillip Allan Publishers 2d ed. 1986)

As pointed out above, unlike economics, income taxation requires precise conclusions on timing. Though the arguments in favor of accretion-based taxation are strong, the arguments in favor of realization-based systems are not without considerable merit and have swayed courts and legislatures. Thus, this analysis does not establish the priority of accretion or realization. Instead, starting with the obvious importance that the concept of realization has to taxation, this comparative analysis addresses its fundamental nature. The analysis concludes that the requirement of realization need not prevent economic income from being taxed to the one who earned it.

362. Clearly a major exception to the doctrine of realization is the treatment of commodity traders who are taxed on the basis of current market value. This is known as the marked to market method. *See* I.R.C. § 1256 (1994). In these cases, there is an established market to value these rights. Also, in requiring such taxation, Congress provided that a portion of the gain (no matter how long the property was held) would be long term capital gain subject to the special maximum tax rate.

363. *See* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954) (holding that a ten-year extension of a franchise to operate a concession was equal to the fair market value of a bridge for tax purposes where the properties had been exchanged in an arm's-length transaction).

364. *See* Burnet v. Logan, 283 U.S. 404, 414 (1931) (holding that the right to receive payments based on future output of iron ore from an iron mine, received in exchange for stock in the mine company, is not capable of valuation, and therefore, should be free from income tax until the taxpayer has recovered her capital investment).

that in most cases parties who bargain have a good sense of value.[365] This may be equally true with people who give away their property, or who convert it to personal use.

The American system's narrower view of realization theory leads to some strange results. The tax benefit doctrine set forth in *Hillsboro* clearly contemplates tax consequences where realization is not thought to exist. This is also true with respect to the Service's position on gifts to individuals and charities. Thus, while realization does not occur under American law, the making of a gift can be a taxable event under the tax benefit doctrine. Indeed, proper application of this doctrine requires the determination of the fair market value of the property involved. While this step is necessary to recoup a deduction that was proper when previously taken, it accomplishes only half as much as the British theory of realization.

American tax accounting theory that is based on clear reflection of income doctrine requires adjustments when the taxpayer uses different accounting methods and then transfers property between his different activities. In that case the taxable event is, in essence, a notional sale for value, similar to the treatment of related taxpayers under transfer pricing requirements. This treatment is based on general tax principles, and not on the power afforded the Service under § 482, though, as we have seen, § 482 may independently apply as well to these dealings.[366] Also, where the necessity for segregating international intra-business transfers exists for sourcing purposes, the rules of realization are partially suspended under American law.

Realization, under British law, is more in accordance with the overall demands of income taxation. Henry Simons said that income tax is a personal tax, a tax on income earned by a person and taxed to that person.[367] Ironically, it was the American system that inspired Simons's thoughts on personal taxation. The British tax system, on the other hand, adopts as its starting point a tax on income from things. Interestingly, the British tax system, through its conclusions about realization and its use of

365. In reviewing these considerations, one should be mindful of the employee who receives property from his employer. The employee clearly has income even though there is uncertainty, measurement may be difficult, and the employee may lack the cash to pay the tax due. A clear distinction in fact between these situations is that the property has been received pursuant to a market transaction, services have been exchanged for property, services have been "sold" for value and, hence, their value has been realized. Also, since this transaction was a commercial transaction with each party presumably trying to get good value for what they are giving up, it is fair to conclude that value was important and was determined.

366. *See* I.R.C. § 482.

367. SIMONS, *supra* note 14, at 47-51.

the concept of notional sales, ensures that, in most cases, the taxpayer actually pays the tax on the economic income generated from his businesses and his property. The American concept allows considerable economic income to escape taxation.

British law shows that the *sine qua non* of realization is not a market transaction. Instead, it teaches that realization is produced by a change in position with respect to property; we look for a dramatic event that tells us it is appropriate or necessary to tax inchoate income. Normally, that economic income is crystallized by a sale. It is made real or confirmed by a market transaction. Necessity, however, dictates that non-market transactions[368] trigger income. Any disposition or termination of an investment, or use of an asset by a taxpayer that presents the real possibility that economic income may escape taxation to that taxpayer, or would fundamentally change the character or other significant tax attributes of that income, should result in a full taxable event.[369] To quote Lord Radcliffe, this occurs when the tax law requires that "part of a taxpayer's activities should be isolated and treated as a self-contained [unit]."[370]

This approach would preserve the general understanding of realization as it applies to property. Fluctuations in value of typical capital assets would still remain untaxed as long as the taxpayer did not terminate his investment by transfer to or from a profit-making activity. Classic realization results in deferral of economic gain, not escape. Any disposition not by way of trade or investment would result in a notional sale for value.

This approach also preserves the purpose behind the doctrine of realization. The doctrine of realization survives because it addresses situations in which valuation may be difficult, gain may be transitory due to market fluctuations, and taxpayers may have difficulty paying tax unless the asset is sold. These factors, however, lack weight in the situations we are considering. When taxpayers voluntarily appropriate property to personal use, they have received and realized the value at that moment in time, in every bit as meaningful a way as those situations where property is transferred from employer to employee. In most cases, there is an es-

368. The term "transactions" is construed in its broadest sense to include internal and external transactions. *See* HENDRIKSON, *supra* note 181, at 142. Accounting theory also recognizes that internal transactions arise from the use or conversion of assets within the firm. *See id.*

369. Not only would this doctrine include actual transfers like gifts and bequests, but it could also include deemed realizations like emigration. *See* INSTITUTE FOR FISCAL STUDIES, *supra* note 166, at 130.

370. Sharkey v. Wernher, 1956 App. Cas. 58, 84 (appeal taken from C.A.).

tablished market for the property. Other taxpayers who desire such property must pay for it at market price.

It must be noted, however, that differences exist between theory and political choice. Policy may vary the result. Thus, the gift or devise of property is an actual transaction disposing of the property, a finalization of the taxpayer's investment, and a realization by the taxpayer of the value of the property through the appropriation by gift. Certainly, United States tax law recognizes this phenomena in the case of a charitable contribution by allowing a deduction of the fair market value of the contribution. Gifts in the United States are considered, for the most part, as nontaxable events with the recipient receiving the donor's cost or basis.[371] Gifts in the United Kingdom are generally treated under the capital gains provisions as dispositions at market value for purposes of the donor and donee.[372] British law, however, does provide non-recognition treatment for a gift of shares or securities in a business.[373] Also, gifts between spouses in the United Kingdom are treated as sales for a price that produces neither gain nor loss,[374] thus affording treatment that is identical with United States law.[375] On the other hand, under British law, dispositions at death, though defined as sales for value, produce no recognized gain or loss to the decedent.[376] The tax outcome is again identical to the outcome under American law.[377] Also, the requirement of a notional sale for value may be suspended in the case of certain gifts to charities.[378] Though, as can be seen, United Kingdom law has reached some of the same conclusions as its United States counterpart, these results

371. Since gifts are not taxable events, they present the possibility that potential losses, incurred by the donor, could be transferred and "realized" by the donee. American law prevents this result with a rule similar to that utilized for conversions from personal to business use. The donor's basis (or cost) received by the donee is limited to the fair market value of the property at the time of the gift, for purposes of depreciation and loss deductions. *See* I.R.C. § 1015.

372. *See* Taxation of Chargeable Gains Act, 1992, ch. 12, § 17 (Eng.).

373. *See id.* § 165.

374. *See id.* § 58.

375. *Compare id. with* I.R.C. § 1041.

376. *See* Taxation of Chargeable Gains Act § 62.

377. *Compare id. with* I.R.C. §§ 102, 1014.

378. In general, legislation provides two exceptions to the doctrine that donations of property to charities are notional sales for value. The 1992 Taxation of Chargeable Gains Act provides at section 257, that, in general, gifts to charities shall be treated as sales for all purposes that would not produce gain or loss. *See* Taxation of Chargeable Gains Act § 257. The 1988 Income and Corporation Taxes Act provides relief in section 84 for the donation of business property to an educational institution. The disposition is not treated as a notional sale for value, and no adjustment need be made in an inventory account for the cost of donated goods, nor a balancing adjustment for prior capital allowances. Income and Corporation Taxes Act, 1988, ch. 1, § 84 (Eng.), *amended by* Finance Act, 1991, ch. 31, § 68 (Eng.).

were founded upon individual policy decisions, and not upon any perceived limitation of the definition of income imposed by the concept of realization.

Likewise, the conversion of property from business to personal use, and from personal to business use, is a fundamental change in the taxpayer's position in relation to that property. This change eliminates the reasons for delay in taxation that sustain the doctrine of realization. The system ignores fluctuations in the market value of property because it expects that the gain or loss will eventually be fixed by a market transaction, or abandoned in the course of business or personal activity. If that happens, gain or loss produced by the particular activity will be determined and treated in the appropriate manner under the system. Instead, upon conversion, the taxpayer's voluntary acts can prevent those events from occurring. The recognition that gains and losses have been realized, subject to exclusions based on conscious policy decisions, would enhance the integrity of the American system, promote fairness to taxpayers, and eliminate complex stop-gap measures.

III. Conclusion

Reflecting on the methodology of this work, this comparative study began with a description of the structure of the general systems of United States and United Kingdom tax law, reviewing how they were created and the context in which they developed. This study did not end, however, with a mere description. It included a study of the law as a mechanism to solve problems or conflicts among people and institutions. Thus, this comparative study has examined theory, structure, and the real world problems with which the law deals.

The purpose of such an analysis is to utilize the tools of normal legal analysis in comparative analysis. The comparative analysis is superior because the setting removes one from reliance on the dogma of one's own system. There is considerable truth in the statement that comparative law's "study renews and refreshes the study of national law, which suffers from confining itself to the interpretation of positive rules and neglecting broad principles in favour of tiny points of doctrine."[379] This work may have, at times, descended into the contemplation of "tiny points of doctrine." Such an approach, however, gives content to, and is necessary in understanding, general principles.

Because the United Kingdom and the United States began with substantial differences in structure, legislative methodology, and even the

379. Zweigert & Kötz, *supra* note 1, at 4.

definitions of income, comparison might have been difficult, if not impossible. It has, however, proved productive because there is much more that is similar about income tax law than is different. Such systems share a common language and a common intellectual debate as to the meaning and extent of income taxation. These systems also share a common objective, to efficiently collect revenue for governments. Income taxation also is generally recognized by governments as a successful tool with which to manipulate conduct. Consequently, income taxation has been advanced furthest by developed economies facing similar economic phenomena. During the time of the most critical development of income tax systems, when they moved away from being just another tax, and towards becoming the most significant generator of revenue in developed countries, there has been considerable interaction between the developed nations.

Thus, in learning about law from a comparison of income tax systems, the conclusion of this Article may well be that the greater the contrast, the greater the level of understanding that can be achieved. In that crucible of comparison, superior foreign solutions may be suggested. In many cases, due to fundamental similarities of income tax systems, these foreign solutions should not be out of step with the conceptual framework of the domestic system, and thus, can be transplanted.

The greatest contrast between the systems identified herein is the structural one. It would be tempting to conclude at this point that one system is demonstrably superior to the other. This Article eschews that result for a less lofty goal, which is to suggest that the different methodologies may suggest different political objectives.

Global systems start with the presupposition that all income is alike, and that it should be taxed in the same manner to achieve equity among taxpayers. This presupposition is shared by the economic theories outlined above. Source-based taxation assumes that income is different depending on its source, and that taxation naturally responds to the differences. Whether prompted by theory or politics, governments have at various times acted to favor one type of income over another. One example has been favoring the taxation of employment income over investment income. Schedular taxation presents the more practical approach to distinguishing income.

Income tax is, however, a tax on net income. Economic theory has largely ignored the practical problems associated with deductions—precisely the area where tax systems vary the most. Through deductions, systems often differentiate between different kinds of income. It is also through the mechanism of deductions that income tax systems traditionally promote or discourage various activities. In order to be truly effective, tax subsidies must be targeted and restricted to the activity intended to be benefitted. To the extent that governments wish to use tax law to achieve particularized political results, schedular principles are necessary.

Comparative analysis suggests as many questions as it provides answers. The analysis herein can only hope to provoke further inquiry.